Ontario

1974

Interim Report

of the

Ont. Legislative Assembly.

Select Committee

on

ECONOMIC AND CULTURAL NATIONALISM

CAPITAL MARKETS, FOREIGN OWNERSHIP
AND ECONOMIC DEVELOPMENT

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* On February 26, 1974 Mr. Newman and Mr. Handleman were sworn as Members of the Executive Council of the Province of Ontario. Since that time they have not participated in the deliberations of the Committee in the formulation of this report, and they accordingly neither subscribe to, nor dissent from the report.

TO: The Honourable Allan E. Reuter,
Speaker of the Legislative Assembly of the Province of Ontario:

Sir:

We, the undersigned members of the Committee appointed by the Legislative Assembly of the Province of Ontario on December 17, 1971, to review the Report of the Interdepartmental Task Force on Foreign Investment and the current status of opinion and information on economic and cultural nationalism in Canada, have the honour to submit the attached Interim Report.

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CAPITAL MARKETS FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT

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CAPITAL MARKETS, FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT

INTRODUCTION

Questions of the availability and allocation of capital have been at the centre of Canadian public discussion of foreign ownership and economic development. The Committee's enquiries included an examination of three major areas of concern about the generation of savings and the allocation of capital in the Canadian and Ontario economies:

(1) The level and adequacy of Canadian savings, especially in relation to the need for foreign capital.

(2) The use of Canadian savings by foreign-owned enterprises.

(3) The adequacy of Canadian capital markets and investment processes in channelling Canadian savings in support of Canadian economic development.

Pursuant to its terms of reference, the Committee gave particular attention to this latter area of concern which is at the heard of the considerations involving the role of foreign investment in the Canadian economy.

The Committee has concluded that financial institutions generally serve the traditional aspects of the Canadian capital markets well. Nevertheless, the Committee has found

that as the Canadian economy has grown and become more sophisticated in terms of its demands on the capital markets, particularly in the venture capital and merchant banking fields, Canadian financial institutions have not kept pace. This Report seeks to identify the areas of deficiency and will make recommendations designed to meet those deficiencies.

LEVEL AND STRUCTURE OF CANADIAN CAPITAL RESOURCES

Historical Background

For most of Canada's history, and much of the period since the Second World War, the prevailing view was that Canada needed large infusions of foreign capital to underwrite high levels of economic growth and development. In the past, much of Canadian development was financed by foreign capital. Major economic infrastructure, especially railways and canals, were financed in earlier periods by imports of capital from abroad. In the post-war period foreign investment was an important element in the substantial growth in the private sector in Canada and particularly in Ontario.

Table 1 describes the pattern of foreign direct investment inflows since 1950, and compares them with business investment. These figures indicate that foreign direct investment was by itself a significant component of gross business investment, but the figures understate the overall importance of foreign direct investment. Supplemented by debt and other funds, the aggregate investment by foreign direct investors was much greater than the direct inflow. In recent years, the relative magnitude of foreign direct investment has declined. In addition, the predominant proportion of investment by foreign-controlled enterprises in Canada has been financed from funds generated in Canada.[1]

The public sector- provincial and municipal governments - also drew heavily on foreign sources of funds to finance its activities.

TABLE 1

FOREIGN DIRECT INVESTMENT AND CANADIAN BUSINESS INVESTMENT 1950-73

Year	Foreign Direct Investment[1] (FDI) (Millions of Dollars)	Business Gross Fixed Capital Formation (BGFCF) (Millions of Dollars)	FDI/BGFCF (Per cent)
1950-54	339.0	4,307.0	7.9
1955-59	486.8	6,637.6	7.3
1960-64	457.0	7,396.2	6.2
1965-69	665.2	14,375.8	4.6
1970	770.0	18,123.0	4.3
1971	880.0	20,527.0	4.3
1972	715.0	22,313.0	3.2
1973	720.0	26,231.0	2.7

Source: Statistics Canada, National Accounts Income and Expenditures and Canadian Balance of International Payments.

[1]Direct investment is equity investment in a control position.

During the same period, as the economy matured, domestic savings increased appreciably. This is documented in Table 2. The overall growth in savings included substantial growth and expansion of contractual savings programs in Canada. In recent years, the level of domestically generated savings approached or exceeded the volume of domestic investment. As reflected in the balance of payments Canada has in some recent years been a net supplier of savings to the outside world.[2] Canadian savings as a proportion of gross national product are substantial, approaching 25%.

In sum, Canadian saving patterns indicate that the economy is, on an aggregate basis, much closer to self-sufficiency than was the case in previous periods especially the late 1950's, and early 1960's. It is exceedingly difficult to measure with precision whether or not the level of domestically generated savings is adequate. There are problems of definition and classification associated with both "savings" and "investment" statistics. There is no universally agreed method of determining what level of investment is "adequate." Even if the level of savings is sufficient in aggregate terms there may be problems of capital availability at the level of individual projects. Nevertheless, there are major indicative measures of the overall sufficiency of domestically generated savings. The two main ones are the deficit, if any, on current account, and

TABLE 2

CANADIAN SAVING IN RELATION TO GROSS NATIONAL PRODUCT AND INVESTMENT 1950-73

Year	Gross Domestic Saving (GDS) (Millions of Dollars)	Gross National Product (GNP) (Millions of Dollars)	GDS/GNP (Per cent)	Business Gross Fixed Capital Formation (BGFCF) (Millions of Dollars)	GDS/BGF (Per ce
1950-54	22,241	113,617	19.6	21,535	103.3
1955-59	28,741	162,536	17.7	33,188	86.6
1960-64	35,524	214,456	16.6	36,981	96.1
1965-69	75,287	331,988	22.7	71,879	104.7
1970	17,986	85,610	21.0	18,123	99.2
1971	20,751	93,402	22.2	20,527	101.1
1972	23,408	103,407	22.6	22,313	104.9
1973	27,239	118,678	22.9	26,231	103.8

Source: Statistics Canada, National Accounts Income and Expenditures.

the level of savings in relation to the volume of investment required for an economy to reach and maintain its optimum level of potential output. The difficulty with the balance of payments measure as an indicator of savings sufficiency is that the forces leading to deficit or surplus on current account are not necessarily associated with Canadian savings or investment processes and needs.[3] Savings sufficiency measured by comparison with the level of investment needed to maintain optimum output and employment suffers from the difficulty of determining what levels and patterns of investment, output and employment are optimal and achievable. Nevertheless, by both standards it appears that Canada is entering a period of greater self-sufficiency in aggregate avings levels.

This does not suggest or imply that Canada could or should discontinue its use of foreign sources of capital. But it does have two main implications. First, the level and need for foreign capital are considerably less than in earlier periods of our economic development. Accordingly, economic policies do not need to be designed to cater as much to the need for foreign capital, or alternatively to be constrained by that need. Secondly, the economy can be more selective in the form and circumstances of capital imports, assuming that Canada and Ontario continue to be attractive to foreign capital of various kinds. Both these matters are discussed further below.

But broad self-sufficiency and adequate aggregate levels of savings in relation to aggregate levels of investment are no guarantee that sufficient capital will be matched with the specific investments and projects needed to develop and sustain a healthy and dynamic economy. Nor is there assurance that all the various objectives which a society might seek to meet - which may include preservation of domestic ownership and control - will be satisfied by a totally freely functioning capital market.

Canada, and especially Ontario, have been exceedingly fortunate in the levels of capital and economic development which they have been able to attract in the last thirty years. Per capita income and the quality of life in Ontario are among the very highest in the world and are a large factor in Canada's high relative economic position in the world. This is, however, no guarantee of future prosperity or of the development of the kind of advanced and sophisticated economic structure to which the people of Ontario and Canada aspire. It is on this basis that a number of basic patterns in the Canadian capital markets have attracted the Committee's and the public's concern. In the Committee's view these patterns merit policy attention.

Sources and Uses of Canadian Savings

A substantial portion of the funds used by the private sector are internally generated. In the order of 80 to 90% of the funds used by the private sector are from sources internal

to the user enterprise, primarily in the form of profits and depreciation.[4] Put another way, the standard pattern in corporate finance in Canada is for enterprises to be substantially self-financing without recourse to the capital market for the bulk of their needs. The 10 to 20% of funds which are sought and obtained from sources outside the firm are nonetheless of critical importance not only to the firm but also to the economy as a whole.

It is these requirements that are met, or not met by capital and money markets. If a firm is unable to obtain funds from external sources it may be unable to expand, or even to continue in business. The same processes which allocate funds to assist business expansion also provide remunerative outlets for the savings of individuals and institutions.

A substantial portion of savings generated in the Canadian economy is allocated to or controlled by foreign-owned enterprises. This phenomenon arises perforce from the fact that a substantial proportion of Canadian industry is foreign controlled. Foreign owned enterprises, which on the whole tend to be more profitable than Canadian owned enterprises, retain a substantial proportion of earnings for re-investment within the firm.[5] In addition, foreign owned enterprises do raise funds from external Canadian sources, primarily from banks, short term money markets and the bond market, but only occasionally from Canadian equity markets.

Foreign-owned enterprises also receive funds in a variety of forms from their parent companies or from other foreign sources of capital.[6] It is these processes which have contributed to the continuous expansion in both absolute and relative terms of both equity and assets of foreign controlled enterprises.[7]

A third characteristic of the source and application of Canadian savings is that there are substantial exports of Canadian capital, principally in the form of portfolio investment in foreign securities, by both institutional and individual investors.[8] In other words, substantial domestic savings that might be allocated in support of domestic economic development through investment in the Canadian capital markets seem to find it more attractive to invest in foreign securities, although there are fluctuations in this pattern. Major institutional investors such as mutual funds and pension funds as well as individual Canadian investors have channelled substantial amounts of Canadian savings abroad.

If Canada is to maintain satisfactory levels of investment, these capital outflows must be offset by inflows of foreign capital to maintain Canadian investment. Indeed, Canada and Ontario have imported substantial amounts of offsetting capital, primarily in the form of foreign direct investment, borrowing abroad (especially through bond issues) by Canadian governments and private corporations, and less frequently by the issue of shares in foreign securities markets mainly in the United States.

The net effect of these patterns of capital market processes has resulted in an increased level of foreign ownership and control of Canadian industry. However, there are indications that new foreign direct investment has declined in importance relative to domestically generated investment in recent years.[9]

It has been noted that the level of inward direct investment is not necessarily a true indicator of the level of investment controlled by foreign enterprises. Typically, inward direct investment is matched up with a substantial amount of additional debt or other funds raised by the foreign investor within Canada. Thus a relatively small amount of foreign equity capital may be in the position of controlling a considerably larger accumulation of assets financed to a large extent by Canadian sourced debt or non-controlling equity capital. In other words, one dollar of foreign direct investment may be in a position of controlling, say $10 of Canadian assets, the remaining $9 being financed from Canadian non-controlling sources.[10]

Accordingly, the overall effect which the capital market, broadly defined, has had in allocating domestically generated savings and imported capital has been to support to an important degree the expansion of foreign ownership of Canadian industry both absolutely and relatively, measured by the book value of either shareholders' equity or assets. In addition, much of the capital allocation associated with new investment has been performed by or associated with foreign owned enterprises in Canada without being subjected to the

decision-making processes of the Canadian capital markets. This may arise either through the application within the firm of internally generated funds (profits plus depreciation) or through an application of funds acquired directly from abroad, either from the parent or elsewhere, without any recourse to the regime of the Canadian capital market. Alternatively, foreign sourced funds have frequently been in the form of controlling equity investment which has been matched up with Canadian debt financing. The Committee has concluded that some of these pattersn are related to deficiencies in the Canadian capital markets which we seek to identify in the next section.

DEFICIENCIES IN THE CANADIAN CAPITAL MARKETS

In many respects Canada and Ontario have very highly developed capital markets and institutions. Many leading financial institutions - many of them with headquarters in Ontario - are of international size and importance in their fields. Some significant innovations and strides have been made in recent years towards developing sophisticated capital market expertise in the Canadian and Ontario economies. The Committee understands that many persons and organizations including prominent members of the investment community are satisfied that the kind and level of financing and support services which Canadian financial institutions are able to provide in support of Canadian economic development are adequate.

The Committee recognizes that the Canadian capital markets do have very substantial strengths and that major strides have been taken in recent years in previously underdeveloped areas, notably in the provision of some kinds of risk capital. Nevertheless, the Committee has identified four areas in which the underdevelopment of the Canadian capital markets merit continuing attention and concern, and for which the government has special responsibilities. These are the venture capital industry; the merchant banking functions; the mobilization and provision of large pools of capital; and the degree and level of entreprenurial finance in the Canadian capital markets generally. All of these are closely inter-related.

Venture Capital

The limited availability of venture capital - risk capital and associated services for the establishment of new enterprises or the launching of new products or ideas - has been a relatively constant complaint in Canadian and Ontario business circles for some decades. In recent years and especially in the last five years, there has been comparatively rapid development of the venture capital function, especially in two or three major Canadian cities. Several new venture capital firms have been successfully launched in central Canada and on the west coast. A number of these enterprises have developed some expertise in tapping the availability of government funds and programs designed to

assist industry generally or small business in particular through the provision of loans or grants, or both, for general development purposes and for certain specific purposes such as exports or research and development.

Governments have also launched their own venture capital operations, although in the past these have been of a relatively modest size. The venture capital programs of the Ontario, Eastern Ontario, and Northern Ontario Development Corporations and to some extent the Industrial Development Bank are examples. The Committee understands that the Canada Development Corporation has acquired interests in several venture capital companies. The Committee notes with interest that there have been recent developments in this connection. We understand that the federal government proposes to expand the venture capital activities of the IDB and to establish a Business Development Corporation to assist smaller businesses. The Ontario Government proposed in its 1974 Budget the establishment of Venture Investment Corporations (VIC's) whereby business corporations investing in a VIC would be permitted to deduct their investments from taxable income and defer income taxes as long as those investments are kept in the VIC. The Budget Statement noted that the impact of this measure will depend to an important extent on the willingness of the federal government to adopt similar provisions.

While recognizing the significant improvements that have taken place in the development of the venture

capital industry in recent years, the Committee is not satisfied that this industry has yet sufficiently developed to be able to support fully the economic development aspirations and objectives of Ontario and Canada. Further capitalization, combined with development of skills in management, marketing and other support services which the venture capital industry specializes in offering would appear to be indicated if the province and the country are to tap to the full their dynamic economic potential.

There would appear to the Committee to be four main areas in which development and expansion of the venture capital industry are needed. First, the size of the industry and its capitalization in support of new ventures need to be expanded. In the Committee's view this could best take place both through expansion of existing firms and through the introduction of new firms so that a healthy and aggressive competitive environment exists in the industry.

In this connection, it is important to note that Canadian firms engaging in the provision of venture capital invest some of their funds abroad, primarily in the U.S. Indeed, some commentators have argued that as much as one half of Canadian venture capital finds its way abroad. It will be necessary to keep this in mind in connection with the development and implementation of policies designed to increase the capitalization of the venture capital industry.

Secondly, the Committee recognizes that a key part of the venture capital function is not merely the provision of funds but also the provision and packaging of key support

services such as entrepreneurship, professional management skill, marketing and distribution, and process technology and new product development. Indeed the view has been expressed to the Committee that it is these aspects which are at least as important as the availability of capital to the success of the venture capital function in an economy.

A third dimension of venture capital industry expansion which would appear to the Committee to be indicated is the regional one. As is the case in many areas of economic development, the venture capital industry appears to have developed disproportionately in major centres, primarily Toronto. There is a need for venture capital and sources to be made more widely available throughout the various regions of the province and country. In this connection the Committee notes that such services need not necessarily be provided by firms which specialize exclusively in venture capital. It has been brought to the Committee's attention that in the United States, locally-based banks tend to be much more oriented toward entreprenurial banking in their local communities than the Canadian branch banking system appears to be. While there are a number of legislative, traditional and business reasons why this is presently so, future changes are not thereby precluded. Specifically, the Committee visualizes an expanded role for existing capital market institutions, such as banks, insurance companies and investment dealers, in the venture capital industry. To be sure, the existing financial institutions have sponsored

such institutions as Roynat which are said to perform a venture capital function. However, the Committee is of the view that these institutions are not sufficiently venture capital oriented in the sense of taking a considerable degree of risk and of taking an active role in terms of providing management, marketing and other support services with respect to businesses in need of venture capital. Indeed, representations have been made to the Committee to the effect that these institutions are not operationally different from the major financial institutions in terms of the types of risk they are willing to take, the considerations taken into account in granting financing, the security which they expect and the support services which they offer.

A fourth important area which the Committee considers critical in the development of an effective venture capital function in Canada concerns the ability of small businesses at an early stage in their development to successfully approach potential sources of capital. Frequently during the course of its hearings, the Committee was told by those engaged in the provision of capital to new or small business that businessmen at this stage of development have little or no idea of how to approach potential sources of capital. They frequently have no understanding of the concept of cash flow and are unfamiliar with the concepts and techniques of financial management. Frequently, they understand little more about their financial operations than

simply that they are in need of funds. Nor do they know exactly how much financing they require or the type of financing best suited to their needs. Moreover, small businessmen simply do not know how to present their case to institutions in an attractive and effective manner. Indeed, the observation is frequently made that businessmen at this stage have well developed entrepreneurial skills yet have woefully inadequate financial and management expertise.

On the other side of the coin, in its discussions with businessmen seeking venture capital, the Committee observed that these businessmen are frequently lacking in information concerning the sources of venture capital which currently do exist.

On the basis of these observations it is clear to the Committee that there is a critical need to develop an intermediation process between businessmen who are in need of financing and potential sources of venture finance. The Committee senses that the lack of intermediation facilities is ultimately responsible for the inconsistent observations made by those engaged in the venture capital industry and by those seeking venture financing. On the one hand, the former observe that there is a dearth of attractive and viable investment opportunities; on the other hand, small businessmen complain that there are totally inadequate sources of venture financing.

The Committee recognizes that the provision of risk capital and the availability of the management, marketing and

other support which the venture capital industry may specialize in providing are not in themselves enough. There must be a steady stream of promising ideas, entrepreneurs and enterprises with which to link up available risk capital. Forthcoming Reports of the Committee will be directed to helping stimulate the various dynamic elements on which future economic development must be based, such as management, entrepreneurial, marketing and technological developments. The Committee also recognizes that entrepreneurs must themselves be prepared to welcome the professional participation of some sources of venture capital in the interests of corporate growth and development.

It is important to emphasize the key role which development of the venture capital industry must play if greater Canadian ownership and control are to characterize future economic development. In the past a very large proportion of the risk capital and entrepreneurship in the Canadian economy has been provided by foreign enterprises and foreign direct investment. A large proportion of the successful new products and enterprises launched in Canada in the last few decades has been undertaken by foreign controlled firms - with the foreign parent playing the role of venture capitalist. To be sure, this has been of considerable advantage to the people of Canada and Ontario. However, many of the cumulative patterns which have resulted from this process are unsatisfactory from a future economic perspective as well as in terms of overall national satisfaction. Development of a strong, aggressive and competitive venture capital industry in support of Canadian

economic development is critical to the achievement of objectives of positive economic nationalism.

Merchant Banking

A second key area where there appears to be a substantial gap or underdevelopment in the Canadian financial system is in the area referred to as merchant banking. The Committee refers particularly to that range of financial and associated entrepreneurial and support services needed to sponsor enterprise growth between the venture capital and mature enterprise stages - the latter typically associated with a major public share offering. A dynamic, highly developed merchant banking function provides growth oriented professional services and sophisticated financial support to small and medium-size firms which show promise of development into full-fledged enterprises.

In the Committee's view this range of corporate growth is critical in the economic life, health and development of the Canadian and Ontario economies. It is important in the achievement of productivity growth - achieving the economies of scale associated with wider markets, the efficiencies or economies of enterprise size, and the linking up or development of the combination of managerial, technological production and marketing strength implied by the mature enterprise. There are also many social benefits that an economy of mature enterprises may bring, such as

stability, security of employment, high level career opportunities, and others.

It has been a characteristic of Canadian economic development that the merchant banking function - the sponsoring of enterprise growth from initial establishment to large size - has been to a substantial extent co-opted by foreign ownership. The very substantial enterpreneurship, direct and indirect financial, technological, managerial and marketing resources of large foreign-based enterprises and their supporting suppliers of financial and other services, have been deployed to sponsor the growth of foreign-owned enterprises in Canada on a broad scale to the point that foreign owned enterprises are disproportionately represented among firms of large size (say over $25 million in assets).[11] The combination of the predomonant presence of foreign ownership in mining and manufacturing and their internally generated and organized patterns of growth obviated the need for the development of a merchant banking function in Canada which might have supported and sponsored the growth of Canadian owned enterprises or of enterprises in Canada generally. The historically greater profitability of the foreign owned sector may also have removed a relative inducement to the development of the merchant banking function.

A merchant bank commits blocks of medium and long term funds on a sophisticated "professional entrepreneur"

basis. A financial package, using a variety of instruments, is usually involved during the course of the merchant bank's relationship with the client firm, but almost invariably involves a substantial equity position (and usually associated management rights). In terms of the package, part of the function of the merchant bank has been to line up other financial participants. Usually the merchant bank is at the centre of financial support as reflected in its equity position.

A critical part of the merchant banking business would be to turn that equity position into a substantial capital gain. It is this process, usually obtained on the enterprise going public, which frees up merchant bank funds for commitment to new business and generates profit on the bank's investment. It may be noted that in relation to a firm making a public share issue timing is critical, both in terms of the firm's evolution, and in terms of the general state of the capital markets.

A merchant bank specializes in being in a position to provide managerial and financial expertise, in combining technological and market strength to produce mature enterprises, and in assisting in the identification of growth patterns and strategies such as new markets, new product lines and key expansion decisions.

The merchant banking function would appear to have economies of enterprise size or scale. On a world wide basis there are relatively few merchant banks; London and New York are the principal centres of merchant banking and

dominate this type of international finance. In recent years there has been an expansion of the international merchant banking function with financial institutions from major industrial countries and especially those of strong currencies such as Germany and Japan becoming active on an international scale.

The merchant banking function is also important in relation to the depth and liquidity of capital markets; this is discussed more fully below. Merchant banks can play key roles in mobilizing the investment groups which large pools of funds represent. Merchant banks also - in their function of sponsoring the growth of enterprises to the stage of a large public share issue - are a key mechanism for generating a diversified and extensive supply of new public share issues. This process of spinning off new and attractive share issues is a key to the development of mature capital markets. These points are considered further below.

Large Pools of Capital for Major Resource and Infrastructure Development

A third perceived gap in the Canadian financial system is its uneven ability to mobilize large pools of capital in support of major projects, especially for infrastructure or resource developments which may involve a relatively high risk, and a relatively long pay-back period. Examples of such projects which have been or may be of special importance to the Canadian economy include Churchill

Falls, James Bay, the Athabaska Tar Sands, MacKenzie Valley pipeline, and others.

As with other capital market gaps, the relative inability of the Canadian capital markets to mobilize sufficiently large pools of capital limits the bargaining power of Canadians to preserve Canadian ownership and control of large projects, especially in the case of major resource development and associated infrastructure. Prospective foreign users of Canadian resources are anxious to find financing because of their need for supplies or security of supplies. These same factors lead foreign investors to seek to retain ownership and control in connection with the provision of capital.

It was pointed out above that the overall level of savings in Canada may be sufficient to finance such major projects. Indeed, the larger financial institutions in Canada, especially the banks and insurance companies, would appear as a group to have the financial resources to participate much more aggressively in developments of this kind.

In this connection, the Committee notes that some commentators argue that the level of savings generated in Canada may not be sufficient, in the aggregate, to finance the many large resource based ventures contemplated in the medium term,[12] as well as to finance other investment. Accordingly, it may be necessary to have recourse to inflows of foreign capital. While the Committee recognizes that Canada may be in the position of financing some of its

investments from abroad, the Committee is convinced that foreign inflows need not necessarily take the form of direct rather than portfolio investment. In the present context, the Committee sees the challenge facing the financial system as being one of mobilizing the necessary funds on appropriate terms behind Canadian ownership and control of major resource projects.

Some have argued that major proposed resource developments are not in the best interests of Canada. Should it be concluded not to proceed with some or all of these developments, the need for mobilizing large pools of capital will become less evident.

Entrepreneurial Finance in the Canadian Capital Markets

The perceived gaps and deficiencies in the Canadian capital markets are in turn associated with certain underlying patterns and problems in the Canadian economy, in the capital markets themselves, and in their relation to other economies and capital markets, especially in the United States. Some of these considerations, and especially the general role and nature of foreign ownership in relation to the capital markets have already been considered. There are several other characteristics of the Canadian capital markets which are associated with its underdevelopment.

Canadian capital markets are characterized by a low entrepreneurial content in providing financing by comparison with other developed countries; by a lack of depth and

liquidity in the capital markets generally, and in the public issue markets specifically; by an apparent lack of effective competition in some financial sectors; and by the close integration of Canadian capital markets with those in the United States. These characteristics of the Canadian capital market are highly interrelated.

It appears to be a characteristic of the Canadian financial system, by contrast with those of the most dynamic economies of the world, that there is a relatively lower entrepreneurial content in the provision of capital and financial services by financial institutions and markets to the private sector. This is generally evidenced by a lower level of risk taking, especially on the part of major lenders or major potential lenders. These observations apply in particular to the larger financial institutions in Canada of which the chartered banks and insurance companies are the most prominent.[13] It would appear to apply as well as a general proposition across most sectors of the financial industry in Canada.

These characteristics of the Canadian financial system are not usefully characterized merely in terms of risk. There are many types of essential financing in any economic system and especially in a developed economy which are or emphasize low risk lending. Financial institutions are in some general sense trustees of other people's money. Bank depositors, insurance policy holders, pension fund beneficiaries, mutual fund shareholders, and persons with assets under

trust company management generally do not wish or expect their financial interests to be primarily or substantially committed to high risk investments. Governments have recognized this in legislative regulation of most financial institutions designed to protect the interests of the depositor, policy holder, pension beneficiary and the like.

The financial institutions involved have also recognized these interests in the investment policies and practices they have adopted. Executives of many financial institutions would respond to the observation that their activities are low in entrepreneurial content by stating that it is not their business or their primary business to be in the provision entrepreneurial finance. Alternatively, they may adopt the view that entrepreneurial finance includes moderate and low as well as high risk ventures and that they do accept risks to a considerable degree.

The Committee is convinced that the large financial institutions could be engaged in more risk taking while at the same time protecting the interests of their depositors, policy holders and beneficiaries. In essence, the investment policies of the institutions involves the balancing of the goal of maximizing the yield, in terms of both income and capital growth, from their investments with the goal of minimizing the risk of loss. It is the view of the Committee that a relatively minor shift towards the goal of increasing yields from investments which a more aggressive policy of

investing in venture situations implies would have a major impact in the availability of venture capital without a significant impairment of the goal of maintaining safety.

It is an important feature of the Canadian financial system that a relatively tight statutory regulatory regime has been imposed on the financial community. This has had two main effects. The first has been to produce a highly segmented financial structure because a reasonably comprehensive set of special purpose statutes regulating financial institutions have served to define the limits within which any particular class of financial institutions - such as banks, trust companies, life insurance companies and finance companies - are free to operate.[14] (Some activities such as deposit collecting aspects of trust compar operations clearly overlap with other institutions). These regulatory statutes generally define and confine the major form of liability accumulation (deposits, premiums, pension contributions, etc.).

The second major impact which these regulatory frameworks have had has been in the restrictions imposed on the forms and patterns of investment or asset accumulation in which most classes of financial institutions may engage. Generally, these statutory requirements have been directed to preserving the financial interests of the individual depositor, policyholder, pension beneficiary etc. These considerations have found expression in rules requiring con-

servative investment programs in assets of demonstrated security and return. Ancillary regulations have restricted financial institutions to certain kinds of operations. Examples of the latter are restrictions on the kinds of collateral which banks may accept under the Bank Act, or restrictions on banks taking equity positions in private firms.

These patterns have been reinforced by most financial institutions in Canada adopting relatively conservative financial practices, including in the case of their investments more active participation in secondary as opposed to primary securities markets. It is also reflected in the expertise which financial institutions have developed. Entrepreneurial finance requires a rather different emphasis and diversity of expertise than does more conservative financing. Specifically, entrepreneurial financing places a greater emphasis on prospective earnings than on present collateral or net worth, or past earnings experience. The kind of expertise and approach required to assess the long term earnings and growth prospects of a product or enterprise are different from those required to assess whether one's loan is secure or whether an enterprise will be able to meet a fixed schedule of repayment of principal and interest. The latter requires skills which are more narrowly financial, and heavily favours the established enterprise with a record of stable cash flow and earnings or conventional security which can be offered as collateral.

Untried firms or products or enterprises seeking finance for a level of operation, production or marketing which they have not yet reached are at a considerable disadvantage even though their earnings potential and profit prospects are very much greater. Entrepreneurial banking requires a broader base of expertise in the range of dynamic business considerations, including assessment of technology, market prospects, growth strategies, and financial management. A somewhat different relationship with the client or funds recipient is similarly contemplated in the two cases. Conventional balance sheet banking is primarily designed to assure that steps can be taken to protect the lender's financial interest, such as foreclosing on collateral. Entrepreneurial finance implies a much more active commitment to the success of the enterprise, both in terms of assessment for capital commitment purposes, and in terms of various kinds of managerial or other assistance which may be provided to aid in or assure the firm's success.

The Committee recognizes that what we have termed balance sheet banking and what is referred to as entrepreneurial banking are not mutually exclusive approaches. In one set of circumstances the conservative balance sheet approach may be appropriate and in another situation a more entrepreneurial, creative approach would be indicated. The Committee notes that the conservative approach of the past may have been in Canada's interest. The Committee suggests, however, that the emphasis on conservativism in investing

policies as reflected in the current legislative framework and in the investment policies of the financial institutions, while perhaps appropriate in the past, may not be appropriate in the present economic environment.

A particular aspect of the conservative practice of Canadian financial institutions and especially banks, is their alleged preference for lending - or lending more, or more willingly - to foreign owned as opposed to Canadian firms. It is indisputable that the financial and other support which a large multinational foreign parent may be in a position to offer its subsidiary in Canada may make lending to the subsidiary a more attractive proposition for a conservative banker, perhaps irrespective of the size and maturity of the subsidiary, than lending to many Canadian enterprises, even some which may be well established. It may also be a factor that the bank may hope the business relations with the subsidiary will lead to major international business with the parent.

The thin capitalization rules contained in the Income Tax Act have the potential of overcoming to some extent this problem.[15] These rules are designed to preclude the artificial deduction of interest on non-arm's length debt of a Canadian subsidiary held by the foreign parent. In substance, these rules prevent the subsidiary from deducting the interest on debt held by the foreign parent which exceeds three times the equity of the subsidiary. However, at present these rules apply only to debt of Canadian subsidiaries held

by controlling non-residents. Thus these rules are easily avoided by having the subsidiary raise the funds on the Canadian capital market and utilizing the guarantee of the foreign parent to secure the debt. To be sure, the purpose of the thin capitalization rules in the tax system is to preclude the artificial deduction of interest on non-arm's length debt. However, these rules have the perhaps unintended effect of encouraging foreign controlled subsidiaries of raising debt in Canada, thus pre-empting funds which would otherwise be available in support of Canadian ownership and control and exacerbating the difficulty which Canadian firms have in obtaining financing. The Committee can see no substantive difference between debt of subsidiaries held directly by foreign parents and debt held by Canadian financial institutions guaranteed by the foreign parent.

Depth and Liquidity in the Canadian Capital Market

The depth and liquidity of capital markets refers to their ability to discharge smoothly the range of functions and demands which mature capital markets are called on to respond. Liquidity refers particularly to the ability of markets to provide buyers and sellers for significant quantities of securities in general or certain securities in particular, so that buyers and sellers are able to obtain or dispose of blocks of securities without having to wait for an uncertain length of time or having to pay a penalty in price because the markets are not able to absorb the sales or purchases of that volume smoothly. Depth in relation to capital markets is a more general concept which refers to the range of types and qualities of securities which the market may offer. Mature capital markets offer a wide range of short, medium and long-term credit facilities, and a variety of types of equity security including both preferred, common and convertible stock, from speculative to blue chip in quality.

It should be noted that the various aspects of the capital markets can not readily be segmented. Mature capital markets systems are able to cope as a matter of course with a variety of patters of funds movement or switches, from short into medium term credit, from long-term credit into cash, from debt into equity or vice versa, and so on. Thus a lack of depth in one major area of the capital markets may affect the overall depth and liquidity of the system as a whole.

Lack of depth and liquidity - as measured in relation to development potential - are characteristic of the Canadian capital markets at the present time, notwithstanding the fact that the Canadian capital markets have made significant developments in this connection in recent years. The lack of depth and liquidity is in turn closely associated with previously identified gaps in the capital market system, especially those in relation to merchant banking and the ability to mobilize large pools of capital for major projects. There are a number of factors underlying the lack of depth and liquidity which may be identified.

The first factor - one which has already been identified - is the pattern of corporate finance in Canada. A very high percentage of funds allocated in the private sector are generated internally. This means that a relatively high proportion of savings, and an especially high proportion of savings allocated to industrial development, are not circulated through the public capital markets. It may be noted that this pattern is common not only in Canada but also in the United States. Yet the U.S. has more highly developed capital markets. Other countries, in western Europe, for example, have a relatively higher proportion of funds financed externally, i.e. financed through the public capital markets.

The application of internally generated funds to internal purposes in effect involves non-financial enterprises engaging in capital markets activities on their own behalf.

Instead of the equity base being expanded through the issuance of new shares, it is expanded through the retention of earnings. This may not involve the issuance of new shares, although over time there tend to be more shares issued either directly or by way of stock splits. Thses observations by no means imply that it is feasible or even desirable to channel all earnings through public capital markets for their conversion into equity. Under North American patterns of share ownership, shareholders expect some appreciation of the value of their share holdings which may in part be founded on increased demand, but the appreciation must to some extent at least be founded on increases in the underlying retained earnings, capitalization or earnings potential of the company. It should be noted also that capital gains in respect of shares can be realized in one of two ways: an increase in the value of shares held; or an increase in the number of shares held at a given price.

The Committee considers that this proclivity of Canadian firms, whether Canadian or foreigh controlled, to retain earnings to the extent of 80 or 90 per cent of total sources of funds and apply them internally is of major importance in connection with the lack of depth and liquidity of Canadian capital markets generally and the equities market in particular. This lack has major implications in relation to the financing and development of Canadian controlled enterprise. The Committee strongly urges that this aspect of corporate finance merits policy attention. The Committee recognizes that a consideration of this question is

a highly complex matter which has far reaching implications. We shall discuss this matter in greater detail below and set out our views in terms of the directions that policy should take.

A second aspect of the Canadian economy which has contributed to the underdevelopment of Canadian capital markets in terms of depth and liquidity relates to the financing of foreign owned firms in Canada. As has already been indicated, subsidiaries of foreign owned firms have themselves performed a large proportion of the entrepreneurial functions in the development of the Canadian economy in the following ways: First, subsidiaries of foreign firms broadly conform to the general pattern of Canadian corporate finance considered above, namely they finance internally a large proportion of their activity. Second, they resort to the entrepreneurial and financial resources of their parent or affiliated enterprises. And third, they account for a good deal of the growth of enterprises in Canada, as reflected in their disproportionate representation among firms of large or very large size. To be sure, foreign owned firms have made use of Canadian capital markets, but generally speaking, such use has not tended to stimulate the development of entrepreneurial depth and liquidity in the Canadian financial system. This is because foreign controlled enterprises have tended to internalize their entrepreneurial activity and finance.

A special feature of the financing behaviour of foreign owned subsidiaries in Canada is that they tend to make

few, if any, of their shares available to the Canadian market. This means that the shares of a great many corporations in Canada, and especially of many of the largest enterprises, are not available for public trading; as a result the capital markets lack the depth they would otherwise have. In this connection it is also important to note the varying impact of shares being issued at different stages of the growth of an enterprise. In most economies the very largest enterprises tend to be the main source of supply of so-called blue chip stock. If some of the larger enterprises in Canada were to issue their shares widely to the public (subject to further observations below) this would improve the supply of blue chip stocks in the Canadian markets adding depth and liquidity to that range of the equities markets and to the capital market system as a whole. But it is also important to the development of the capital market that firms make their shares available publicly at various stages of their growth, and not only when they reach blue chip status. Mature capital markets need a continuing supply of equities of corporations which are in more speculative or developmental stages when they go public. In addition, just as the merchant banking function may sponsor the growth of enterprises from the stage of being a relatively new venture through to the public share issue stage, capital markets if they are fully developed aid in the smooth transition of enterprises from the developmental stages through to mature, blue chip enterprises. It is apt to recall that telephone companies at one time represented a high

risk, new technology and growth industry as compared to their staid, regulated bule chip status in the 1970's.

It should be noted in relation to foreign owned subsidiaries in Canada that their reluctance to make shares available to the Canadian markets is perhaps compensated for in part by the shares of certain parent companies being listed on Canadian stock exchanges. This is by no means equivalent to the volume of shares which would otherwise be available if share distribution were proportional to the number of corporations in Canada of public share issue size, or to economic activity. This is especially true because a number of parent companies with large subsidiaries in Canada do not make their shares available in Canada. In any event, the strategic impact in terms of the goals of economic nationalism of the trading of shares of foreign parent corporations on Canadian markets is not the same as it would be if the shares of the Canadian subsidiary were made available on Canadian markets.

At this juncture, it should be recalled that the underdevelopment of the merchant banking function in Canada is related to the underdevelopment of the public securities markets in Canada. One of the principal roles of a merchant bank is to spin off new public share issues of enterprises in whose growth the bank has participated. The impact of foreign ownership on the merchant banking function has already been noted.

A third factor which contributes to the lack of depth and liquidity in the capital markets is that large firms, through

the skillful application and manipulation of internal cash flows, are able to perform to a limited extent the kinds of functions discharged by commercial banks or other lending institutions. Firms are able to enlarge their credit through the skillful management of their own receivables and liabilities, including money management which takes account of the fact that liabilities do not accrue to fall due in the same pattern as revenues, so that the amount of cash required to discharge liabilities as they fall due may be considerably less than the overall level of liabilities. The financial principles underlying this pattern are analogous to those under which the banking system operates to expand the credit base by some multiple of cash on hand, because the demand for cash by depositors is at any given time only a small percentage of the banks' total liabilities to depositors. In relation to the total economic system, the management of cash flows by non-financial corporations permits the system to enlarge credit without the direct intervention of capital market processes.

To be sure, the skillful management of cash flows is an important and legitimate aspect of sound corporation finance. Moreover, the Committee has not identified this particular pattern of corporation finance in Canada as being any different from those abroad. Nevertheless, the Committee identifies this pattern as one factor which contributes generally to the thinness of the capital markets.

If a larger proportion of economic activity were financed through the capital markets - if a larger proportion of

both savings and decision making were channelled through the capital markets - this would in itself create greater liquidity in the capital markets, primarily because the mere volume of transactions can have major impacts on liquidity. To achieve this result involves fundamental changes in matters of both taxation and corporate finance in Canada. These changes require extensive and careful research.

It should be emphasized that these factors are pointed out as comparative features of the Canadian markets, and as an explanation of why the Canadian capital markets have less depth or development than they might otherwise have had. The finding of solutions is a good deal more complex. An answer does not appear to be to require all foreign owned firms to make their shares available in Canada, although this might be done on a selective basis. A major constraint on across-the-board requirements is that shares of truncated subsidiares are not necessarily likely to be attractive investments, even though they may be large by financial measures. Similarly, even if foreign ownership has had a restraining or stultifying effect on the development of, say, the merchant banking function, this is not in itself sufficient reason to engage in general repatriation to Canadian ownership or control. Many other factors must be considered in assessing these questions. Share participation and Canadian control are discussed below in a broader context. Gaps, depths, and deficiencies must be noted for attention in connection with positive and developmental measures in support of Canadian economic activity.

Implications of Lack of Depth and Liquidity

The relative lack of depth and liquidity in the Canadian capital markets has substantial impacts on flows of Canadian and imported savings. Because of the lack of depth of Canadian markets as reflected in the smaller range of investment opportunities or securities, large volumes of Canadian savings have been channelled into portfolio holdings of foreign securities. This has been especially important in respect of Canadian institutional investors such as pension and mutual funds.[16] Such institutions are highly sensitive to the liquidity aspects of capital markets. Because they are committing large blocks of funds, they often require a high degree of liquidity and market depth in the specific securities or range of securities in which they seek to invest. The limited number of investments of this kind available in Canadian markets has led many institutional investors in Canada to invest heavily in foreign securities markets, especially in the United States. In this way, substantial blocks of Canadian savings are channelled abroad.

Changes in Canadian federal income tax law, especially in 1971, provided a strong inducement for Canadian pension funds, and more minor inducements for others, to invest more of their funds in Canada. While techniques of this kind may help to keep domestic savings in Canada, they do not by themselves solve the problem of depth, liquidity and development of Canadian capital markets, processes and institutions. Positive policies to remedy these deficiencies are required.

Individual Canadian investors have also been heavy investors in foreign securities. Presumably the greater range of more active issues available in the New York markets in particular has been associated with that phenonenon. Common brokerage firms on both sides of the border and other institutional linkages are also contributing factors. In this connection, the Committee notes that it has frequently been alleged that Canadians are less inclined towards risk taking in investments than others. A variant of this argument has been that foreign direct investment was needed because sufficient Canadian risk takers were not available to invest in Canadian economic development. While the risk taking capacities and proclivities of Canadian financial intermediaries may be open to question, the Committee has concluded that there is no evidence to support the general proposition that individual Canadians are less inclined to take risks than Americans in comparable income groups. However, there is some evidence that individual Americans invest more on a per capita basis than Canadians. This largely results from the fact that there is a relatively higher concentration of population in upper income groups in the United States than in Canada. While it may be true that Canadians on a per capita basis channel their savings heavily in conservative financial instruments and life insurance, nevertheless, they also invest relatively heavily in securities generally and equities specifically in given income groups.[17]

There are prominent characteristics as well to the pattern of capital flows into Canada. These include heavy foreign

direct as opposed to portfolio investment, and large debt issues floated in foreign capital markets primarily by provincial and municipal governments and to some extent by private corporations. It is not unfair to characterize these offsetting patterns of capital flows as the Canadian economy exchanging non-entrepreneurial portfolio investment for capital inflows of a much higher entrepreneurial content, especially in the cases of foreign direct investment and of large pools of debt capital for major resource developments (including those undertaken by governments or Crown corporations). These patterns suggest that Canada is, in conceptual terms, a substantial importer of capital market liquidity and entrepreneurship unavailable in domestic markets.

Integration of Canadian and American Capital Markets

These observations point to another major feature of Canadian capital markets. One of the important factors in capital market patterns in North America generally is the substantial and relatively long-standing integration of the Canadian and American capital markets, in that Canadian centres of finance tend to have the features of regional financial centres of the New York markets rather than being a distinctive capital market in the way in which some European financial centres have developed.[18]

There are a number of obvious factors which have contributed to the integration of the Canadian capital market with that of the United States. The interpenetration of the two economies, especially the American into the Canadian, common

commercial and financial practices, substantially similar approaches in many areas of capital market regulations particularly securities regulations, a tradition of freedom from controls on foreign exchange or capital movements,[19] common institutions in many areas of the economy especially in financial markets, common language and a similar culture have combined to reinforce the integration of the Canadian and U.S. capital markets. Specifically the openness and integration of the Canadian and American economies and financial systems have led to many of the capital market functions being performed for the Canadian economy through foreign ownership and through recourse to the more developed U.S. capital market. With the development in recent years of European and Japanese capital markets and institutions, and the substantial participation of Japanese and Western European financial institutions in global capital markets and their substantial integration with those of the North American capital markets Canada has also become a participant in this global economic integration. It is perhaps significant that Canadian participation has generally taken the form more of Canadian borrowers taking advantage of foreign capital markets than Canadian institutions making a substantial contribution to the development of these wider capital markets. Some Canadian banks have, however, been involved in international consortia and are moderately active in the soliciting business in the highly competitive markets for international finance.

In this connection, the Committee notes that the general

sources of finance on an international level may be shifting somewhat. With the recent substantial increases in the price of oil, the Arab nations have begun to accumulate rapidly vast amounts of capital, far in excess of what their economies can currently absorb. As a result those nations are seeking attractive yet secure investment opportunities. The Canadian and Ontario economies would appear to be attractive to the Arabs in this regard.

The Committee is advised that the Arab nations are investing substantial funds in a variety of financial instruments on a portfolio basis. This is in contrast to the proclivity of Americans for direct investment. The Arab nations may therefore be a source which Canada and Ontario might tap for inward portfolio investment. This could be used to offset a decline in foreign direct investment from the United States.

Moreover, Canada as a nation has an interest in diversifying internationally the sources of our external financing. Indeed, one of the major concerns about foreign investment in Canada has been that by far the largest proportion of that investment has been sourced in the U.S. The vast new accumulations of capital of the Arab nations combined with their interest in engaging in portfolio investment in Canada and Ontario would appear to present an ideal opportunity for Canada and Ontario not only to shift from direct to portfolio foreign investment but also to diversify the sources of our external finance.

Especially with the very large resource-based ventures

such as the MacKenzie Valley pipeline, the Athabasca tar sands and the like looming on the horizon, Arab sources of portfolio finance may well become an important element in the financing of those ventures if we want to maintain control in Canadian hands.[20]

The Committee understands that a number of American financial institutions are very actively involved in servicing the investment needs of the Arab nations. The Committee has very little information about the involvement of Canadian financial institutions in providing the Arabs with financial services on the one hand and in attracting Arab portfolio funds to Canada on the other hand. The Committee notes that there are indications that some Canadian financial institutions, primarily banks, are contemplating initiatives in these directions. Yet, the Committee is not aware of any major efforts on the part of Canadian financial institutions. It would appear that there is considerable scope for Canadian institutions in both areas.

Balance of Payments Considerations

The Committee notes that different configurations of capital movements have different balance of payments implications, depending on whether the exchange rates are floating or fixed, whether Canadian monetary and fiscal policies are expansionary or restrictive, the general macro-economic performance of the economy in relation to other economies, the structure and level of current account transactions, and whether there is a current account deficit or surplus.

Put another way, economic adjustments between the Canadian economy and the rest of the world through the balance of payments, may take place through internal adjustment (contraction or expansion of the economy), through external adjustment (change in the exchange rate) or through specific adjustments (changes in the various components of the balance of payments such as merchandise trade, invisibles or capital account) with or without the intervention of alternative commercial, monetary and other policy measures. Typically, the Canadian economy adjusts to the world environment by a combination of these three adjustment mechanisms, the basic approach being a matter of the relative emphasis in policy terms among the three.

For a large part of the period since the early 1950's Canada was on a floating exchange rate until 1962 when the rate was pegged at 92.5 cents, U.S. The Canadian dollar was floated again in 1970. In fact, for most of the 1950's and 60's the basic balance of payments and development strategy adopted by the Canadian Government for the Canadian economy was to finance a deficit on current account through capital imports. This meant that Canada was a net importer of foreign savings, a significant proportion of which was foreign direct investment. Capital inflows aided in financing economic development in Canada. These inflows were in turn associated with substantial imports such as machinery and equipment exacerbating the balance of payments deficit on current account.

In the past several years a rather different balance of payments and policy configuration has developed for the Canadian economy. The economy is no longer as substantially in need of capital inflows as previously to finance current account deficits associated with the desire for economic growth. In fact, in some recent periods Canada has enjoyed trade or current account surpluses leading to Canada being a net supplier of savings to the rest of the world.

In addition, the Canadian economy now operates in an environment of floating exchange rates, which Canada has in common with most of the non-communist world. This, together with th recent international monetary realignments, the need for reforms and the concomitant uncertainty, have different policy implications from the environment prevailing in the past. Accordingly, under present circumstances, and for the short or medium term, in the absence of off-setting imports of goods and services, capital inflows are likely to have the effect of putting upward pressure on the exchange rate, making Canadian exports, especially those relatively more sensitive to change in price, less competitive abroad. At the same time, as the exchange rate rises, foreign goods become more competitive in the Canadian market.

At the present time, a relatively high exchange rate in terms of U.S. dollars results from very high levels of raw material exports from Canada, and leads to a substantial and growing deficit on manufacturing account. Capital inflows may be offset by capital exports, neutralising exchange rate effects.

On the other hand, for the Canadian economy it is somewhat more difficult in policy terms to generate capital exports in support of exchange rate policy. It is customary and desirable that there be a mixture of flows in each direction. Nonetheless, the present environment invites a consideration of various alternative patterns and configurations of capital inflows and outflows, alternatives and tradeoffs. For example, should Canadian exports of capital be rechannelled in support of Canadian economic development? Should Canadian entrepreneurship, ownership and control be substituted for at least some foreign direct investment? Should Canada undertake huge resource ventures which require large inflows of capital?

Capital movements also have other balance of payment consequences. Specifically, they generate flows in the future of interest, dividends or other payments, or repatriations of capital. In the case of direct investment a more complex range of flows may be involved than with portfolio investment as there may be transactions in royalties, managment and other business services, and a variety of other indirect payments associated with prior foreign direct investment.[21] Both portfolio and direct equity investment usually involve larger repatriation amounts than the initial infusion of capital or principal. In the case of direct investment retention of earnings is more subject to the investor's control than it is in the case of portfolio investment. Future repatriations of foreign equity investments, whether in the form of direct or portfolio investment, are likely to be valued by reference to

market prices prevailing in Canada at the time of repatriation. We shall consider the desirability of foreign portfolio as opposed to direct investment below.

Outflows associated with capital inflows in previous periods must be met either by further capital inflows, exports of goods and services, or offsetting inflows associated with previous capital exports from Canada. Canada runs a substantial deficit of the order of two billion dollars annually, on interest, dividends and other net payments arising from capital flows. Gross flows are somewhat higher. A significant proportion of the gross outflows is accounted for by interest, dividends, royalties, licence fees and payments for business services associated with foreign direct investment.

If these outpayments are met from export revenues they are appropriately lumped with all current account transactions. If they are financed by capital inflows, in effect the economy is borrowing at a future cost to meet current service payments. On the other hand, if repatriation of capital or repayment of principal abroad are financed from exports or other current account revenues, the capital obligations of the economy are being repaid in real terms. If repatriations of capital are financed or offset by capital inflows, the liabilities on capital account are in effect being refinanced.

A detailed examination of the way in which the Canadian economy should most appropriately offset outpayments associated with prior capital inflows is beyond the scope of this discussion.

It is the view of the Committee in connection with future capital transactions and their associated payments that certain main considerations be kept in mind. First, do the benefits associated with specific capital inflows or specific levels of capital inflows exceed the costs of these inflows in terms of their impact on the degree of ownership and control of the Canadian economy, on the exchange rate, on the balance between the manufacturing and the resources sectors, on economic development and on employment?

Questions of this nature are likely to be at the heart of future considerations regarding the desirability of mass capital inflows for the financing of major infrastructure or resource development projects, such as the MacKenzie Valley pipeline or associated oil and natural gas development.

Second, are the levels of out-payment contemplated for future time periods appropriate in the light of the benefits received by the Canadian economy, in terms of investment, technology, management, etc., including any displacement effects on the development of Canadian capacity?

Third, is the pattern of capital inflows and outflows important in terms of achieving optimal levels of Canadian economic development and consistent with retention of Canadian ownership and control? Specifically, how can Canadian savings currently channelled into capital exports be rechannelled in support of Canadian economic development and substitute for reliance on foreign direct investment? Can the requisite entrepreneurial content be found in Canada and matched with Canadian capital?

Competition in the Canadian Capital Markets

An additional factor bearing on the overall efficiency and effectiveness of the Canadian capital market system, and also bearing on its liquidity, is the degree of competition within the capital markets generally and with specific financial sectors or industries. Various segments of the capital markets have been criticized as being insufficiently competitive with detrimental results in terms of capital markets performance in support of Canadian economic activity and development, and in terms of costs and levels of financial services provided. Banking and underwriting have been particularly singled out in public and professional discussions as insufficiently competitive. Most financial industries in Canada are dominated by a few very large firms. Relatively few firms account for a relatively large proportion of the business of that industry. In Ontario this pattern would obtain in most of the financial industries including banks, trust companies, investment dealers, loan companies, sales finance companies and to some extent in mutual funds or pension funds.

It should be noted that these service industries are generally exempt from the operation of the Combines Investigation Act, although it has been proposed that they may be subject to proposed new competition legislation. Most financial institutions (venture capital firms are an important exception) are subject to special purpose incorporation and regulatory statutes such as the Loan and Trust Companies Acts both federal and

provincial, the Bank Act, the Canada and British Life Insurance Companies Act, Provincial Insurance Companies Acts, Securities Acts, Investment Companies Acts, and various legislation bearing on sales finance and consumer credit. Virtually all these industries are also subject to fixed rules restricting foreign equity participation. However, it should be noted that these regulatory frameworks do not address themselves to competition policy.

The effect of the foreign equity rules is to place a barrier to entry into the Canadian industry by new foreign owned firms (although this may be subject to discretionary control in the case of the investment industry under the regulations of the Securities Act governing foreign ownership). As a general rule, barriers to entry may serve to foster or facilitate a less competitive environment in the industry, although this factor clearly does not exhaust the considerations which might be taken into account.

Competition policy aspects in relation to the foregoing discussion would appear to be most important in the case of banks and underwriting syndicates. In both cases it is frequently alleged that there is an unduly "clubby" atmosphere that obtains within the industry and among the leading participants, leaving them to behave somewhat more like a co-operative cartel than an aggressively competitive industry. Different considerations may however apply in considering barriers to entry by foreign owned firms.

Even were such a change in policy indicated, the Committee is satisfied that public opinion would not favour

relaxation of the present restrictive ownership rules governing financial institutions in Canada. There would appear to be broad popular support for the existing designation of financial institutions as key sectors subject to rules restricting entry by foreign firms.

The Committee appreciates that there is a considerable degree of competition for the big accounts or the relatively well developed business in the financial industry; in other words, there does exist what the Committee would term rivalry for the "cream" of the business in the financial sector. However, the Committee senses that in respect of the harder to get business or the relatively undeveloped areas of the financial business such as venture capital and merchant banking, that quality of competition necessary to develop those areas is not evident. Indeed, even if foreign firms were permitted completely free access to presently protected sectors, the Committee is of the view that new foreign firms would also become engaged in the rivalry for the "cream" of the business.

In addition, the Committee is of the view that the 25 - 10 rule which currently applies to key sectors of financial industries does in fact permit limited entry into the Canadian financial industries. In fact, the Committee notes that the experience of the First National City Bank in connection with its interest in Mercantile has been satisfactory. The requirement to comply with the 25 - 10 rule permits the Canadian firm to advertise that it is Canadian owned and controlled.

The Canadian banks have lately been advocating relaxation of the foreign ownership restrictions, which in practice operate to deny Canadian banks entry into other countries which insist on reciprocity of treatment for their own banks. Some would argue that the Canadian banks should concentrate rather more of their attention in entrepreneurial financing in Canada rather than seeking to expand into international markets. While there is no doubt some merit in this line of argument, too narrow a view of this kind would serve to deny the Canadian economy the benefits of participation in international markets by its leading financial institutions. A further consideration which has been advanced in previous public discussions concerning the potential presence of foreign banks is that large foreign controlled banks with access to their parents' financial resources might be in a position to undermine or weaken the monetary policy objectives of the Bank of Canada or the Government of Canada. Although the latter are not without sanctions which they might invoke to discipline foreign banks who were to behave in this way, these factors cannot be ignored. The activities of financial institutions in trading money through foreign exchanges at very rapid rates in connection with recent monetary developments and world wide inflation have seriously undermined rather than strengthened the confidence which governments and others may have in the willingness or ability of leading financial institutions to pursue independently the public interest. The instabilities associated with substantial movement of funds across foreign

exchanges has caused governments or international monetary authorities to reconsider the largely laissez-faire approach to multinational financial enterprises.

Lack of competition in the securities industry and specifically among investment dealers has been alleged to be associated with the lack of liquidity of the Canadian underwriting markets. In effect this argument alleges that the small number of leading firms in the underwriting business has been able to take advantage of their dominant position to assure a quiet but steady flow of lucrative business rather than to take an expansive and entrepreneurial posture with respect to the development of the underwriting function in Canada. This specifically finds expression in the informal rules governing the organization or leadership of underwriting syndicates in the Canadian markets. While it is apparent from a number of indicators that ways should be sought to encourage rather more aggressive and entrepreneurial competition within these industries, it is less apparent that this can necessarily be achieved especially in respect of the entrepreneurial function, or achieved most efficiently, through opening the door to foreign owned firms. It might be as plausible that the more substantial presence of foreign owned financial institutions would merely provide additional pipelines for the importation of foreign entrepreneurship and liquidity rather than the development of strengths of these kinds in Canada. Particularly as entrepreneurial finance is as much a matter of the development and deployment of a broad range of professional skills in all

aspects of business management, it would appear that more direct measures would be indicated with a view to developing the capacities of the Canadian financial sectors. More aggressive competition policy, irrespective of ownership, is also indicated.

The Committee believes that public policy in connection with the financial industries should encourage new concepts and approaches outside the traditional financing activities of firms. There is a need for new, aggressive entrepreneurial activities to correct the indentified deficiencies in the capital markets. Government encouragement of developments along these lines are indicated.

POLICY ALTERNATIVES AND RECOMMENDATIONS

As the foregoing discussion indicates, domestic and international capital markets processes are exceedingly complex and wide ranging in their operations and ramifications. The Committee recognizes the importance of this complexity. Nonetheless the Committee has detected widespread dissatisfaction with the present operation of the capital market and how it relates to the support of Canadian economic development, particularly development subject to Canadian ownership and control. The Committee attaches special importance to this concern in relation to positive measures in support of Canadian ownership and economic development, lest the underdevelopment of Canadian capital markets processes sponsor a temptation to revert to an alleged but spurious "need" for foreign capital and control of the pattern of future economic development. The Committee has concluded that continued and intensified efforts should be made to develop, strengthen and expand the institutions, processes and mechanisms for channelling Canadian savings in support of Canadian ownership and economic development. The Committee notes that there have been a number of measures introduced through the Federal Income Tax Act that are directed to encouraging the channelling of Canadian savings into Canadian securities. In the 1974 Ontario Budget, the Government revealed its plans to permit the establishment of Venture Investment Corporations.

As the Ontario Government noted, the degree of success of this technique in providing significant amounts of venture capital depends upon its adoption by the federal government.

The Committee welcomes these developments. Further efforts, especially in respect of entrepreneurial finance, appear to be indicated. It should be emphasized, of course, that these processes do not merely require capital - but also appropriate business opportunities.

Provincial Role in the Capital Markets

The provinces, and especially Ontario, already have an important jurisdictional role in the capital markets. The Securities Act provides a major regulatory framework for a large range of debt and equity instruments which are publicly traded, and the Toronto Stock Exchange is the senior exchange in Canada. Many specific financial sectors, such as loan and trust companies, and some insurance companies are subject to provincial legislation.

In other areas such as banking and to a lesser extent insurance, mortgage and sales finance companies, the federal government is more important or predominant. The federal government has given recent indications in the case of mutual funds that it will attempt to expand substantially its control over capital markets processes in Canada.

The Committee notes that the role of Ontario in the capital markets both directly and indirectly is consider-

able and is founded on jurisdictional regulation of major areas of the financial sector. Even in those areas where there are powerful arguments for some or predominant federal regulation, at the very least there is a role for the Province of Ontario to make an input into policy and administration.

In terms of provincial input the Committee notes that there is already in place in the Ministry of Consumer and Commercial Relations staff and organization for the administration of the statutes and regulations governing financial institutions. The Committee has not, however, been able to identify within the Ontario government structure a branch, division or ministry with expertise and orientation towards the economic functioning of capital markets in Ontario and Canada. This in part reflects a number of the considerations the Committee has identified in the foregoing discussions, especially those governing the general philosophy of regulation of financial institutions in Canada.

The Committee nevertheless feels that it would be desirable if a capital markets branch or division were established in an appropriate Ministry of the Ontario Government to give closer analytical attention to capital market processes in Canada and between Canada and other countries, and to provide professional analysis and advice in support of a revised role for the Ontario government in capital markets and in federal/provincial aspects of capital markets regulation.

Accordingly,

THE COMMITTEE RECOMMENDS THAT THE GOVERNMENT OF ONTARIO ESTABLISH AN APPROPRIATELY STAFFED BODY IN THE MINISTRY OF INDUSTRY AND TOURISM TO MONITOR CANADIAN CAPITAL MARKETS AND TO PROVIDE PROFESSIONAL ANALYSIS AND ADVICE IN RELATION TO CAPITAL MARKET PROCESSES.

The Committee understands that the Government has undertaken some studies of the capital markets. However, it is not evident to the Committee that there is in place within the Ontario government a systematic and ongoing process of the kind contemplated by the Committee.

In accordance with the Committee's foregoing discussions, the Committee recommends that this body not only emphasize the availability of capital, but also examine critically on an ongoing basis the appropriateness of the institutional structures in the capital markets, and the skills and postures deployed behind the allocation of capital in support of Canadian ownership development, and especially in the area of entrepreneurial finance. Specifically, the goals of the recommended body would include the following:

(1) To enhance the ability and willingness of the capital markets to support Canadian ownership and control.

(2) To identify specific gaps in the capital markets and to make recommendations to the government and others as to how these gaps might be remedied.

(3) To develop and execute an effective venture capital service in the sense of providing those in need of this type of financing with information as to sources of venture capital and how to make presentations to those sources.

(4) And to monitor the interface of the Ontario capital market with those of the rest of Canada and with international capital markets.

In this connection, the Committee notes that one important function of this body would be to assist Ontario institutions in exploring and developing, to a greater extent than has been done in the past, sources of capital alternative to those located in the U.S. This would be done with a view to promoting the goals of achieving a greater geographic dispersion of our foreign sources of capital and of developing foreign portfolio investment rather than foreign direct investment.

The Committee visualizes that this body would be most appropriately established within the Ministry of Industry and Tourism. In substance, the Committee sees the role of the recommended body as a developmental one - to assist in the development of capital market institutions in the indicated directions, and not as a regulatory or controlling one. For this reason, the Committee believes that it would be most appropriate to establish this body within the Ministry of Industry and Tourism which already has a developmental role

rather than in the Ministry of Consumer and Commercial Relations or the Ministry of Treasury, Economics and Intergovernmental Affairs which currently tend to have a regulatory or controlling role.

Foreign Portfolio vs. Direct Investment

The Committee has concluded that in the future foreign investment should take the form of portfolio rather than direct investment to the extent that is prudent and practicable. The Committee bases its conclusions on several factors. First, the promotion and encouragement of foreign portfolio as opposed to direct investment will further the goal of supporting across a broad front Canadian ownership and control. Second, the fact that major controlling equity positions in Canadian industry are located in Canada will mean that the residual benefits of ownership and control will accrue to the benefit of the Canadian shareholders and Canada generally. This is, in a general sense, the familiar concept of leverage. In the present situation, it would appear that Canada as a nation is underleveraged in most industrial sectors of the economy. The promotion of foreign portfolio investment relative to direct investment would help relieve this imbalance.

Third, a further sort of leverage to be achieved is a public policy leverage. To the extent positions of control in most sectors of the economy will be situated in Canada, the various sectors will be more amenable to Canadian

public policy regulation and less amenable to regulation, direct or indirect, by foreign governments. Moreover, Canadian control will mean that decisions about Canadian economic development are made in Canada. The Committee is convinced that decisions made in Canada by Canadian controlling interests are more likely to be in Canada's interest than decisions effectively made abroad by foreign controlling interests.

In view of the above considerations,

THE COMMITTEE RECOMMENDS THAT CANADIAN ECONOMIC POLICIES PROMOTE FOREIGN PORTFOLIO INVESTMENT AND DISCOURAGE FOREIGN DIRECT INVESTMENT.

It is important to note that this recommendation does not mean that equity participation by foreign firms should be precluded altogether. The Committee is concerned only that <u>effective</u> control be retained in Canada. This means that foreign firms could participate by way of debt or equity, provided that the combination of foreign debt and equity participation does not carry with it effective control.

The Committee is convinced that the world economic environment is now such that Canada can, as a nation, insist that foreign inflows of funds be primarily in the form of portfolio rather than direct investment. First, we have noted above that in aggregate terms the level of Canadian

savings appears to be closer to self-sufficient in relation to aggregate desired investment. The problem is to channel Canadian savings in support of Canadian ownership and control. The Committee is of the view that an effective, well articulated public policy in this regard will provide the impetus for the Canadian capital markets to do just that. Second, the relative scarcity of natural resources on the world level enhances Canada's position with respect to investment in the natural resources sector.

Third, the pattern of world sources of funds has been shifting in recent years. Although the United States is still a very important factor, its importance as a source of funds is declining. The European capital markets, Japan and more recently the Arab nations are becoming increasingly important sources of funds. Along with this geographical shift in the sources of funds, the Committee notes that there is a qualitative shift as well. The Committee understands that European, Japanese and Arab investors are relatively less interested in equity investments than are the Americans. This greater interest of Europeans, Japanese and Arab investors for portfolio investment matches the Committee's recommendation to promote foreign portfolio investment and to discourage direct investment.

A geographical dispersion of the sources of funds upon which Canada draws will render an added advantage to Canada. Currently, a great proportion of foreign investment in Canada is sourced in the U.S. For a variety of reasons

this is of concern to many Canadians. With Canada drawing on a greater variety of world sources of funds in the future, this concentration of investment will to some degree be ameliorated.

The Committee is not convinced that the Canadian capital market has sufficiently explored sources of funds alternative to those in the United States. The Committee visualizes a number of reasons for this, primarily the close proximity of the U.S. capital market in terms of distance, common language, institutions and similarity of modes of operation. Nevertheless, the Committee is convinced that much can be done to make greater use of alternative world sources of funds, especially in view of the very large resource ventures looming on the horizon.

On the basis of these considerations,

THE COMMITTEE RECOMMENDS THAT GREATER ATTENTION BE GIVEN TO DEVELOPING AND TO DRAWING ON FOREIGN SOURCES OF CAPITAL OTHER THAN THE UNITED STATES.

In implementing this recommendation, the Committee visualizes an important role not only for the institutions of the Canadian capital market, but also for the Government of Ontario. The Committee has recommended the establishment of a body in the Ministry of Industry and Tourism, among other things, to monitor the capital market in Ontario. One important function of this body should be to assist the

Ontario institutions in exploring and developing these alternative sources of capital. A government involvement in this connection may be invaluable in dealing with such sources of funds as the Arab nations and Japan where government involvement is extensive.

Thus far we have considered the future role of foreign investment. We have recommended that this role be limited to the extent practicable to portfolio investment. At this stage of the analysis, one must consider how in practical terms this is to be accomplished.

The screening process established by the long considered and recently enacted Foreign Investment Review Act will of itself, to some degree at least, serve to limit direct investment by non-residents. This is in effect accomplished in a number of ways. The mere fact of non-residents having to submit their proposed takeovers or new ventures to the screening agency which is in effect empowered to bargain for increased Canadian ownership will have some effect in that direction. Nevertheless, the screening process does not apply to expansions of existing foreign controlled firms in related industries. As a large proportion of the economy is foreign controlled, this is a major gap in the screening process. It can be expected that a considerable part of the future development of the Canadian economy will come from the expansion within existing industries of foreign controlled firms.

We shall consider later in this report some techniques which could be used to limit foreign investment to portfolio investment and to support Canadian ownership and control.

Review of Legislation Respecting Financial Institutions

The Committee has already identified the relatively tight regulatory framework governing financial institutions and processes in Canada as one of the factors which appears to be associated with a number of capital markets problems. These include rigidities in the system, a lack of entrepreneurial content in capital allocation in Canada, less than effective competition in some industry sectors, and, substantial investment by Canadian institutions in foreign securities. To be sure, these problems cannot be attributed solely to the type of regulatory framework. Nor is it clear to what extent these problems are accounted for by that framework. Legislation concerning financial institutions has, in the past, been based on the goal of investor protection. The goal of developing an effective and vibrant capital market may conflict to some degree with the goal of protecting the financial interests of investors.

The major philosophy behind legislation governing financial institutions has been the protection of the individual interest of the depositor, policy holder, pension beneficiary and so on, depending on the nature of the institution. This, in turn, reflects concerns which may

have developed in earlier periods when financial institutions collapsed or suffered major setbacks. The Committee considers these protective objectives to be of continuing importance. At the same time, it would appear to the Committee that consistent with appropriate investor protection, the economic functioning of financial institutions and capital market processes could be strengthened through revision and modernization of the statutory frameworks within which the major financial institutions now operate.

THE COMMITTEE ACCORDINGLY RECOMMENDS THAT THE PROVINCE OF ONTARIO INITIATE, IN CO-OPERATION WITH THE FEDERAL GOVERNMENT, A REVIEW OF THE LEGISLATIVE FRAMEWORK GOVERNING FINANCIAL INSTITUTIONS AND PROCESSES WITH A VIEW TO IMPROVING THE ECONOMIC FUNCTIONING OF THE CANADIAN FINANCIAL SYSTEM IN SUPPORT OF CANADIAN ECONOMIC DEVELOPMENT AND OWNERSHIP OBJECTIVES.

Such a review might have particular regard to changes which might be introduced which would have the effect of increasing major entrepreneurial content in the investment and lending policies of financial institutions in Canada, especially where this can be accomplished through the deployment of greater professional skills in investment or enterprise assessment, rather than merely by incurring greater risks. Specific requirements to allocate the bulk of their investment

dollars in Canada should be considered as specific requirements, along the lines of the rules now governing pension fund investment in the Federal Income Tax Act. Such investment rules, especially in the case of mutual funds, should take account of other recommendations of the Committee such as the development of the merchant banking function and the generation of new equity issues with which that would be associated, and requirements that foreign owned subsidiaries make shares available to Canadians on a selective basis.

The Committee notes in this connection that the decennial revision of The Bank Act is scheduled to take place in 1977. This process of revision could readily take into account the review recommended by the Committee in order to incorporate the above goals into the legislative framework concerning chartered banks.

While the Committee's recommendations are directed primarily to strengthening capital market processes in support of industrial activity, the Committee notes that there are other major important claims on the capital markets. Government borrowing and mortgages for housing are leading examples of important types of investment which the capital markets may be called on to make. These and other areas have difficulties attracting sufficient funds from the financial system from time to time, as do those areas to which the Committee has directed its attention. In the review of capital markets policies, legislation and practice which the Committee recommends, it does not intend to imply that other government

and social priorities such as housing should necessarily take a lower priority than industrial growth and development.

Study Concerning Servicing Outpayments

The Committee considers that it is appropriate to re-examine systematically the levels and outpayments associated with foreign direct investment. Much of the debate surrounding the foreign ownership issue has involved the question of whether outpayments associated with foreign direct investment are appropriate relative to the benefits received from foreign direct investment. The Committee is not aware of any study which makes such an examination on a continuing and systematic basis. Accordingly,

THE COMMITTEE RECOMMENDS THAT A SYSTEMATIC AND CONTINUING STUDY BE UNDERTAKEN TO EXAMINE THE LEVELS OF OUTPAYMENTS ASSOCIATED WITH FOREIGN DIRECT INVESTMENT IN RELATION TO THE BENEFITS RECEIVED FROM THAT INVESTMENT.

The Gray Report undertook a qualitative study, in aggregate terms, of the broad implications of foreign direct investment on the balance of payments. The industry-specific studies produced by Kates, Peat, Marwick & Co. for the Committee and published separately by the Committee also considered largely qualitative implications of the balance of payments effects of the operations of specific foreign controlled firms in selected industries. Both of these approaches

were largely qualitative in nature and represented single studies which were not ongoing. In connection with the above recommendation, the Committee visualizes an ongoing, quantitatively oriented study. Perhaps, such a study could most appropriately be undertaken by the Foreign Investment Review Agency established under the Foreign Investment Review Act, as that body has a continuing interest and an active involvement in this area.

Development of Merchant Banking

THE COMMITTEE RECOMMENDS THE GOVERNMENT OF ONTARIO TAKE STEPS TO DEVELOP A MERCHANT BANKING FUNCTION IN ONTARIO AND IN CANADA ON A PRIORITY BASIS.

The Committee recognizes that this area of development would most appropriately take place through co-operative efforts between the federal government and the provinces.

The Committee recommends that these efforts have as their objective the establishment of new merchant banking institutions, and the broadening of the merchant banking function performed by the existing financial institutions. These should be directed to developing a much more substantial degree of entrepreneurial finance among the leading financial institutions in Canada, especially the chartered banks, and to sponsoring new major institutions specializing in merchant banking functions.

These functions should specifically include the deployment of capital in support of enterprise growth, in

combination with supporting management services. They should also include facilities for mobilizing pools of capital appropriate for developments in Canada. The generation of public share issues of mature or maturing enterprises should be the principal technique for assuring the circulation of capital in the merchant banking function.

To accomplish these ends,

THE COMMITTEE RECOMMENDS THAT THE PROVINCE OF ONTARIO IN CONSULTATION AND CO-OPERATION WITH THE FEDERAL GOVERNMENT AND THE GOVERNMENTS OF OTHER PROVINCES, SPONSOR THE DEVELOPMENT OF NEW LEGISLATIVE AND TAX REGIMES WHICH WOULD BOTH GOVERN AND STIMULATE THE DEVELOPMENT OF THE MERCHANT BANKING FUNCTION IN CANADA.

Measures of this kind should be introduced in combination with the previously recommended review of legislation governing the existing financial institutions, and especially the chartered banks. Means should be developed to eliminate unnecessary constraints in the areas of equity investment and collateral particularly those constraints which may inhibit chartered banks from engaging in a greater degree of entrepreneurial finance. Provision might also be made for other financial institutions such as life insurance companies to develop entrepreneurial finance capabilities.

In addition,

THE COMMITTEE RECOMMENDS THAT A SPECIFIC NEW LEGISLATIVE REGIME GOVERNING INSTITUTIONS SPECIALIZING IN MERCHANT BANKING BE ESTABLISHED TO GIVE MERCHANT BANKING INSTITUTIONS THE APPROPRIATE POWERS AND OBLIGATIONS TO DISCHARGE THE SPECIAL NATURE OF THE FUNCTIONS WHICH THEY WOULD PERFORM IN THE CANADIAN AND ONTARIO ECONOMIES.

A special and complementary tax regime should simultaneously be established to encourage the expension and development of the merchant banking function. This should include preferential tax treatment of earnings recommitted to the merchant banking function to assure an appropriate emphasis on the part of merchant or development banks in sponsoring corporate growth. Appropriate tax treatment would also need to be designed to stimulate spinning off public share issues to enhance the opportunities for individual and institutional Canadian investors to participate in the Canadian economy, to channel additional funds into the merchant banking institutions, to add to the depth and development of Canadian capital markets, and to assure the continued growth and development of the merchant banking function itself.

Special policy and legislative attention should be given to encourage the deployment of professional assessment, managerial and related business skills required for the development of merchant banking institutions. Changes in the legislative system governing financial institutions and in the tax system are required to encourage a relatively greater

willingness to accept risks or to minimize risks through managerial participation and the provision of supporting business services.

In a later section the Committee recommends an expanded role for the Government of Ontario and the Ontario Development Corporations, including expansion into merchant banking activities. In addition, the Committee recommends the Government of Ontario enter into joint ventures with the private sector to launch new merchant or development banks within the framework of the proposed new legislative and tax regimes.

THE COMMITTEE RECOMMENDS THAT IT WOULD BE APPROPRIATE FOR THE GOVERNMENT TO PARTICIPATE TO THE EXTENT OF UP TO 50% OF EQUITY WITH PRIVATE INVESTORS AND APPROPRIATELY QUALIFIED MANAGEMENT AND PROFESSIONAL TEAMS TO ASSURE THE EARLY DEVELOPMENT OF A SUBSTANTIAL MERCHANT BANKING INDUSTRY IN ONTARIO AND CANADA.

The Committee does not recommend that it be mandatory that all merchant banks or financial institutions engaged in merchant banking admit government participation as a condition of participating in the merchant banking industry.

The Committee recognizes that there are some who feel that this form of government participation in what they consider to be the exclusive preserve of the private sector is inappropriate. It is argued that governments should not compete with the private sector, either because it is thought

that the appropriate role for government is to fill in only where the private sector cannot, or because the government by virtue of its special position and substantial resources is in some sense an unfair competitor. A slightly different line of argument emphasizes the danger that government participation may be seen by some investors as a guarantee of the success of the venture, and that these investors would expect the government to underwrite losses if the venture fails. A further argument is that it is not appropriate for government to take risks in the private sector.

Others propound a somewhat different rationale for government participation of the kind recommended above. It may be argued that it is in general desirable for the government to be a partner in ventures of this kind because of their broad economic and more indirectly social importance. It is further argued that the private sector's long record of having failed to develop in this area both suggests that the government can hardly be said to be competing with the private sector in this area, and argues that a need exists for government participation in order to get the development of the merchant banking function off the ground.

In any case the Committee would recommend that provision be made for the government to withdraw - through the public distribution of its equity position - from enterprises of this kind should the circumstances seem appropriate.

THE COMMITTEE RECOMMENDS THAT THE MERCHANT BANKING INSTITUTIONS BE ENCOURAGED TO MAKE THEIR SERVICES AVAILABLE IN ALL REGIONS OF ONTARIO AND CANADA.

Particular attention should be given to avoid a situation whereby the availability of the services performed by the new merchant banking institutions is concentrated in a very few centres. Indeed, some have argued that capital market services generally are now available in only relatively few Canadian centres. The Committee is anxious to avoid such a situation in relation to the new merchant banks. Particular attention should be directed to ensure that the new merchant banks are developed on a regional basis to ensure a responsiveness to the needs of all regions of Ontario and Canada.

Finally, the Committee believes that it would be especially desirable to involve both commercial banks and investment dealers in the development of the merchant banking function. There are several reasons why the Committee considers it especially desirable to involve these institutions. First, they are at the present time among those institutions in the best position to mobilize funds now available under present institutional arrangements in support of Canadian economic development. Second, it is those sectors among existing financial institutions for whom a substantial increase in entrepreneurial content of their activities would appear to be most appropriate and indicated. Third, these institutions are among those in which a more aggressively

competitive environment would be desirable in connection with these new areas. Involvement of these institutions in merchant banking would serve, not only to generate a greater degree of competition within the individual industries, but also to generate competition between the sectors. In this connection, the Committee notes the possibility of the federal government making provision for provincial participation in chartered banks, or in the launching of new banks.

THE COMMITTEE RECOMMENDS THAT ALL MERCHANT BANKS IN ONTARIO AND CANADA BE AND REMAIN CANADIAN CONTROLLED, AND SUBJECT TO THE 25-10% FOREIGN OWNERSHIP RULES. THE BOARD OF DIRECTORS OF THE MERCHANT BANKING INSTITUTIONS SHOULD BE AT LEAST 75% CANADIAN AS A STATUTORY REQUIREMENT AS IN THE BANK ACT.

Government Sponsored Expansion of the Venture Capital Industry

With a view to sponsoring and supporting the expansion of venture capital industry in Ontario, particularly in its regional dimension,

THE COMMITTEE RECOMMENDS THAT THE GOVERNMENT SPONSOR THE DEVELOPMENT OF NEW VENTURE CAPITAL FIRMS IN ONTARIO.

(i) Venture Investment Corporations

In the 1974 budget, The Honourable John White, Treasurer of Ontario, proposed the establishment of Venture Investment Corporations ("VIC") to participate in the financing of small Canadian businesses (those qualifying for

the federal small business deduction). The proposal involves a tax flow-through from a business corporation investing in a VIC. The corporation would be allowed to deduct its investment in a VIC from its taxable income in order to defer income taxes until its investment in the VIC is withdrawn.

The budget recognizes that the degree of success of this proposal depends upon its adoption by the federal government under federal income tax legislation. Moreover, the proposal does not contain an opportunity for individuals to participate in this tax incentive.

If the Venture Investment Corporation proposal is acted upon,

THE COMMITTEE RECOMMENDS THAT THE VENTURE INVESTMENT CORPORATION PROPOSAL INCORPORATE PARTICIPATION BY INDIVIDUALS.

If the VIC proposal is not acted on in the near future, the Committee recommends that the technique outlined below to stimulate the venture capital industry be adopted.

(ii) Joint Venture Corporations

As an alternative to the VIC proposal advanced by the Government,

THE COMMITTEE RECOMMENDS THAT THE GOVERNMENT OF ONTARIO TAKE EQUITY POSITIONS OF UP TO ONE-THIRD WITH A VIEW TO LAUNCHING NEW REGIONALLY-ORIENTED VENTURE CAPITAL FIRMS, UNDER APPROXIMATELY QUALIFIED MANAGEMENT.

The firms should have a minimum capitalization in the order of 1.5 million dollars, and should emphasize attracting shareholders from the region or communities in which they are located, and to which their venture capital investment efforts are directed.

It would be the role of the government both to sponsor the launching of these enterprises through taking a substantial initial seed money position, and to assure that the proposed venture capital company management is suitably professionally qualified and organized to give the project reasonable possibilities of success. The government should not itself assert management control, but would be entitled to representation on the board of directors.

For its part, the venture capital company would have two principal missions. The first would be to provide a channel for, or encourage, investment by local individuals and institutions - generally small investors. This would give local individuals in particular an opportunity to invest in local enterprises, and thereby in the development of the local regional community, the other principal mission of the venture capital firms. In terms of types of ventures selected for participation or assistance, these government sponsored venture capital firms would invest primarily in specific regions of the province, although for reasons of flexibility, such as to provide for the possibility of linking up with technological or marketing strength elsewhere,

the enterprises should not be wholly restricted to local perspectives. Government sponsorship should not be limited to a single venture capital company in each region. In a number of regions it might be desirable for there to be competition between such venture capital enterprises, although some parts of the province might be unable in terms of opportunities to support effectively more than one such enterprise.

Because of government involvement it would be necessary for the government and the venture capital enterprise in its approach to individual investors to stress the risk and entrepreneurial nature of investments in venture capital. Special efforts should be made to provide prospective or actual investors with detailed information which will aid them in assessing the extent to which they would be interested in investing in the enterprise and it should be made clear to investors that the government does not guarantee the investment.

With a view to attracting and encouraging small investor participation in regional venture capital enterprises, the facilities of the Ontario Government Savings Offices might be employed.

Provision should be made for the government equity participation to be liquidated in appropriate circumstances. However, it should be ensured that, at all times, ownership, control and management remain substantially Canadian.

It occurs to the Committee that the VIC proposal contained in the Budget and the proposal of this Committee with respect to joint venture corporations could be combined in the future should the government's VIC proposal be adopted.

(iii) Assistance in Approaching Sources of Capital

The Committee noted above the critical need to develop an assistance program to assist small business in approaching prospective sources of expansion capital. Accordingly,

THE COMMITTEE RECOMMENDS THAT PRIORITY BE GIVEN TO THE DEVELOPMENT OF AN EFFECTIVE INSTITUTIONAL PROCESS, DESIGNED ON THE ONE HAND TO INFORM THOSE IN NEED OF FINANCING ABOUT THE POTENTIAL SOURCES OF VENTURE CAPITAL AND TO IMPROVE THEIR ABILITY IN MAKING ATTRACTIVE AND EFFECTIVE PRESENTATIONS TO THOSE SOURCES AND ON THE OTHER HAND TO BRING SOURCES OF VENTURE FINANCE IN CONTACT WITH THOSE REQUIRING IT.

In this connection there is a role for both the private sector and government. Indeed, the Committee understands that some private businesses have developed offering services for a fee to businesses in need of venture financing to assist them in the evaluation of their needs and in the preparation of prospectuses to support their approaches to

sources of capital. The Committee welcomes and would encourage developments along this line. The government's role is the stimulation of such developments and the dissemination of information concerning the availability of venture capital services.

Expanded Roles for Ontario's Development Corporations

The foregoing recommendations on the merchant banking and venture capital industries contemplate a more substantial and aggressive role for the Ontario government, especially in equity and financial participation in such enterprises.

Complementary to these proposals, the Committee has a number of other suggestions and recommendations involving expanded roles for Ontario's Development Corporations. Prior recommendations respecting merchant banking and venture capital might themselves be incorporated within the framework proposed below.

The Committee notes that at the present time there are three Ontario Development Corporations: the Ontario Development Corporation, the Eastern Ontario Development Corporation, and the Northern Ontario Development Corporation. The Committee understands that further government ventures may be contemplated for resource exploration and development. The Committee's findings and recommendations with respect to natural resources will be presented in another report.

The Committee has reviewed the general nature of the present programs of the O.D.C., E.O.D.C., and N.O.D.C. The Committee has noted that some programs, such as the Venture Capital Fund, are available only to Canadian enterprises, while assistance through loan programs may be available to foreign owned enterprises as well, if it is deemed by the corporation involved or the government to be in "public interest". The Committee has noted that the Ontario Development Corporation has promulgated a list of considerations which may be taken into account in assessing whether or not the public interest would be furthered by loans to foreign owned corporations.

The Committee endorses the view that individual investment projects require a case by case approach as to the implications or desirability of Canadian as opposed to foreign ownership. These matters will be discussed further in connection with the administration of the Foreign Investment Review Act, and in conclusions and observations of the Committee with respect to specific industry sectors. At the same time the Committee advocates and recommends that Ontario's Development Corporations adopt a preference for Canadian owned firms in their loan program, while recognizing that there may be special circumstances, regional or other considerations, or the possibility of persuading foreign direct investors to tailor the nature of their operations to cater more to economic and social objectives of Ontario.

THE COMMITTEE RECOMMENDS THAT IN OVERALL TERMS THE PREDOMINANT PROPORTION OF ONTARIO DEVELOPMENT CORPORATION LOANS BE MADE TO CANADIAN OWNED ENTERPRISES.

In addition, the Committee has concluded that it would be desirable for the functions of Ontario's Development Corporations to be substantially expanded.

THE COMMITTEE RECOMMENDS THAT THE SCOPE, POWERS AND RESOURCES OF ONTARIO'S DEVELOPMENT CORPORATIONS - OR ANY OTHERS WHICH MAY IN THE FUTURE BE CREATED - BE EXPANDED TO PROVIDE FOR A CAPABILITY IN A NUMBER OF AREAS IN WHICH THEY ARE NOT NOW ACTIVE.

The Committee recommends that Ontario's Development Corporations examine a variety of forms of equity participation as appropriate techniques for meeting economic and other objectives of the province. There are a variety of forms which such participation may take, and variety of objectives which they might be directed to achieve.

First, minority equity participations might be more appropriate to meet the development objectives contemplated by O.D.C. loan or similar programs. Especially where government grants may be involved, it may be appropriate for Ontario's Development Corporations to take equity positions. These could be retained indefinitely, sold at a future time to founding or other shareholders, or disposed of to third parties.

Provision should also be made for Ontario's Development Corporations to have the power and resources to enter into selected joint ventures with the private sector, as representatives of the Ontario government. Joint ventures along this line are contemplated and recommended above in connection with merchant banking and the venture capital industry. The joint venture technique might also be particularly appropriate in respect of mineral exploration or development. More generally it is a technique which could be used for a variety of purposes as considered appropriate by the government.

THE COMMITTEE ALSO RECOMMENDS THAT ONTARIO'S DEVELOPMENT CORPORATIONS BE EMPOWERED TO SECURE THROUGH ACQUISITION A GOVERNMENT OR CANADIAN PRESENCE IN SELECTED INDUSTRIES.

This technique is one which is employed to advantage in a number of European countries such as Great Britain, France, Italy and several other European countries. It involves considerations similar to those contemplated by the proposed National Oil Corporation in Canada, or in a former period by the Polymer Corporation. Recently, the governments of several other Canadian provinces - indeed, most other Canadian provinces - have acquired a substantial government interest in an important industry, a number involving pulp and paper. The Committee notes that these

investments or acquisitions have been motivated by a variety of considerations.

Government equity participation - joint ventures or otherwise - in selected industries through Ontario's Development Corporations would give the government an inside understanding and feel for those industries. On the basis of its discussions with European government and business leaders, the Committee has concluded that a direct involvement in industries is invaluable for governments in the development and execution of economic policies. The Committee particularly notes the highly beneficial experience which the U.K. government has had in relation to its participation in British Petroleum.

A special role which proposed investment or acquisition powers on the part of Ontario's Development Corporations would have might be with respect to the possible repatriation of foreign owned corporations to Canadian ownership on a selective basis.

THE COMMITTEE RECOMMENDS THAT THE ONTARIO'S DEVELOPMENT CORPORATIONS BE SUITABLY EQUIPPED WITH THE LEGAL AND FINANCIAL CAPACITY TO UNDERTAKE REACQUISITION OF ENTERPRISES SHOULD THAT BE DEEMED IN THE PUBLIC INTEREST, TO ACQUIRE ENTERPRISES COMING UP FOR SALE FROM FOREIGN OWNERS FOR WHICH NO CANADIAN BUYER CAN BE FOUND, PROVIDED THAT THE ACQUISITION IS IN THE PUBLIC INTEREST, AND TO ACQUIRE ON A TEMPORARY BASIS CANADIAN CORPORATIONS WHICH WOULD OTHERWISE FALL INTO FOREIGN OWNED HANDS.

The Committee notes that there are some difficulties involving the role of government in private market places for companies or corporate ownership and control. The Committee is, however, satisfied that these problems can be obviated. Specifically, the Committee is of the view that government participation should not involve a change in the status of the corporation with respect to competitive conditions and taxation. Such corporations should be operated in the same way as would privately owned corporations.

THE COMMITTEE ALSO RECOMMENDS THAT THE DEVELOPMENT CORPORATIONS ESTABLISH PROGRAMS TO PROVIDE ASSISTANCE TO CANADIANS FOR THE ACQUISITION OF FOREIGN OWNED ENTERPRISES OR CONTROL POSITIONS BY ONTARIO AND CANADIAN INTERESTS.

While the Committee does not have in mind an active program to promote such repatriation, except as contemplated elsewhere in the report, the Committee does feel that mechanisms to assist in repatriation when the opportunities arise, should be provided by Ontario's Development Corporation.

THE COMMITTEE RECOMMENDS THAT THE GOVERNMENT AND ONTARIO'S DEVELOPMENT CORPORATIONS EXAMINE THE POSSIBILITY OF PROVIDING CONCESSIONAL FINANCING FOR THE MACHINERY, EQUIPMENT AND ENGINEERING SERVICES ASSOCIATED WITH PROJECTS WHICH ONTARIO INDUSTRY IN THESE AREAS IS EQUIPPED TO PROVIDE.

In connection with commissioned studies of the mining, forest-based and engineering consulting industries, the Committee encountered concern that foreign bidders on projects frequently had the benefit of concessional financing assistance provided from their home countries, and that Canadian bidding groups or syndicates are at a competitive disadvantage. It would appear to be well within the scope of appropriate policy in Canada for concessional financing to be made available with respect to Canadian bidders on Canadian or Ontario projects. Especially in areas connected with resource development where the Canadian industry is relatively large, it would be logical for Canada to develop engineering machinery and construction equipment industries. In fact, Canada has been a heavy importer of such services and equipment. The Committee makes further observations on these matters elsewhere but feels that concessional financing would be an appropriate type of program for Ontario's Development Corporations.

In recommending the substantial extension of the role of Ontario's Development Corporations, the Committee does not have in mind that these should develop into mechanisms for the general indirect subsidization of economic activity in Ontario or specific enterprises. With respect to all the above recommended roles for Ontario's Development Corporations

THE COMMITTEE RECOMMENDS THAT ONTARIO'S DEVELOPMENT CORPORATIONS CONDUCT THEIR AFFAIRS ON THE BASIS OF SECURING REASONABLE RETURNS ON ALL THEIR INVESTMENTS IF POSSIBLE.

Enterprises in which the development corporations have equity positions should be operated on the basis of normal commercial principles. To the extent that this is not possible, the development corporations should reconsider their positions to ensure that government participation is not used simply as a subsidization device.

Thin Capitalization Rules

The Committee noted above that the thin capitalization rules as presently framed have the unintended effect of encouraging foreign controlled subsidiaries of raising debt in Canada, thus pre-empting funds which would otherwise be available in support of Canadian ownership and control. Accordingly,

THE COMMITTEE RECOMMENDS THAT CONSIDERATION BE GIVEN TO EXTENDING THE APPLICATION OF THE THIN CAPITALIZATION RULES ALONG THE LINES OF EXCLUDING THE DEDUCTION OF INTEREST ON THE EXCESSIVE DEBT OF FOREIGN CONTROLLED SUBSIDIARIES WHERE THAT DEBT IS ULTIMATELY GUARANTEED BY THE FOREIGN PARENT.

The Committee notes that "normal" debt-equity ratios vary considerably among industries. For example, the normal

debt-equity ratio for a utility is considerably greater than for, say, the computer software industry. In this sense, an extension of the thin capitalization rules in the recommended direction would require a recognition that debt-equity ratios do vary between industries. Therefore, the Committee would suggest that the concept of "excessive debt" contained in the above recommendation be made flexible to recognize the particular circumstances of various industries. In this connection, the Committee would suggest that the maximum permissible debt-equity ratios for particular industries for the purpose of the thin capitalization rules be established from time to time by regulation.

Capital Market Depth and Minority Positions

The Committee has concluded that an important characteristic of the Canadian economy is that a high proportion of private sector finance involves the application within the firm of internally generated funds without the intervention of external capital market processes. Moreover, the Committee has concluded that this aspect of the Canadian economy merits careful policy attention. Accordingly,

THE COMMITTEE RECOMMENDS THAT CANADIAN ECONOMIC POLICY INCLUDE PROGRAMS DESIGNED TO EXPAND THE PROPORTION OF PRIVATE SECTOR ECONOMIC ACTIVITY FINANCED THROUGH THE CAPITAL MARKETS.

In addition, the Committee has concluded that Canadian held minority positions in foreign controlled corporations should be encouraged for a number of reasons including the fact that the existence of Canadian minority interests are invaluable in ensuring that Canadian economic interests are included in the decision-making processes of foreign controlled firms.

One technique which commends itself to the Committee is that advanced by Louis Kelso which involves a combination of financing techniques and an employee remuneration scheme. This technique or an adaptation thereof will serve to promote some of the goals of economic policy in relation to foreign ownership which the Committee has identified.

(i) The Kelso Technique

The Kelso technique involves the establishment of an Employee Stock Ownership Trust ("ESOT") the beneficiaries of which are the employees of the corporation. The corporation seeking financing, rather than itself going directly to the capital market, would obtain financing indirectly through the ESOT. The corporation would go to the lender and arrange the financing it requires. The lender loans the funds, not directly to the corporation, but to the ESOT. The ESOT would in turn subscribe for newly issued equity shares in the corporation. The corporation guarantees the loan to the ESOT.

The lender is in effect in the same position as it would be without the use of the ESOT since its loan to the ESOT is guaranteed by the borrowing corporation.

The corporation, on its part, receives the financing it requires. However, at the same time it involves the employees of the corporation by giving them an opportunity collectively to become shareholders of the corporation without any cash outlay on their part. The share issue to the employees' trust is financed by the loan to the employees' trust. That loan will ultimately be retired through the earnings of the corporation.

The ESOT retires the loan by obtaining funds from the corporation in amounts that would be required to retire the debt if the loan had been made directly to the corporation. In other words, the corporation contractually commits itself to make those periodic payments to ESOT. The contractual obligations of the corporation to the ESOT mirror those of the ESOT to the lending institution. However, at the present time under Canadian tax law, the payments made by the corporation to the employees' trust would not be deductible to the corporation. The tax considerations are considered below.

Under the proposals advanced by Kelso, an institution which is called a Capital Diffusion Insurance Corporation ("CDIC") would be established to guarantee the loans by institutions to the employees' trust. The

functions of the CDIC would be much like those of the CMHC which currently insures NHA mortgages for housing. In this way, Kelso suggests, the risk of loss in the scheme would be borne by society as a whole. The justification for spreading the risk throughout society in this corporate finance technique is analogous to the justification of insuring mortgages in the housing sector. In other words, the social goals promoted by this technique warrants that society accept the minimal risks of loss involved in this technique.

Upon ceasing employment, an employee would be entitled to take his interest in the ESOT in, say, the form of cash, shares in the corporation, or some other form of asset. It would be necessary to work out the details in this connection.

(ii) Tax Considerations

Under Canadian income tax law, the payments made by the corporation to the ESOT are not deductible to the corporation. In other words, presently, payments to the employees' trust by the corporation would be in after tax dollars. Compared with a direct loan, the corporation would be at a tax disadvantage under the Kelso technique because with a direct loan the corporation could deduct the interest.

To make the Kelso technique work practically, it would be necessary for Canadian tax law to be amended to

permit the corporation to deduct the payments to the employees' trust. However, it should be noted that this is a major incentive for corporations to use the ESOT vehicle. Although a corporation can currently deduct interest for tax purposes, it cannot deduct principal repayments. But under the Kelso technique with the appropriate changes in the tax provisions, the corporation can, in effect, deduct not only the interest but also the principal. In summary, the adoption of the Kelso technique would involve a major incentive to encourage the use of the ESOT vehicle.

(iii) Securities Law Considerations

There are considerable problems in terms of the application of the securities legislation and regulations to the issue by the corporation of its shares to the employee trust. The problem with respect to public companies which already report under OSC requirements would be relatively small. The major problems arise with respect to those corporations not now subject to OSC requirements. An exemption could be included in the Securities Act to the effect that as long as the shares are held in the employees' trust, issues to the trust would be exempt.

The Committee is concerned, however, not so much with the issue of the shares which are publicly traded, but more with encouraging the shares of presently closely held corporations to become publicly traded in order to expand

the depth and liquidity of the markets and to afford Canadians the opportunity of holding equities in firms that are currently wholly foreign controlled. The Kelso technique is a mechanism which would achieve those goals. However, in connection with closely held corporations, the Committee is concerned that the present requirements of securities legislation and regulations would have the effect of effectively preventing the shares issued by the corporation to the ESOT from ultimately finding their way on to the public markets.

The Committee is of the view that the issue of shares by the corporation to the ESOT should be exempt from the OSC prospectus filing requirements. The Committee believes that a summary procedure should be available to facilitate the distribution of shares from the ESOT to the employees beneficiaries and ultimately to the public. In this connection, the Committee recommends that distributions of shares made available to public markets via the ESOT vehicle should be exempt from the prospectus filing requirements. Those requirements should be replaced with a more summary and less cumbersome qualifying procedure.

(iv) Recommendations

THE COMMITTEE RECOMMENDS THAT CONSIDERATION BE GIVEN TO THE ADOPTION OF THE EMPLOYEES STOCK OWNERSHIP TRUST (ESOT) TECHNIQUE IN ORDER TO IMPROVE THE DEPTH AND LIQUIDITY OF THE CAPITAL

MARKET AND IN ORDER TO ENCOURAGE AND FACILITATE THE ISSUE OF SHARES BY FOREIGN CONTROLLED CORPORATIONS TO CANADIANS.

To implement this recommendation,

THE COMMITTEE RECOMMENDS THAT CANADIAN TAX LAW BE AMENDED TO PERMIT CORPORATIONS TO DEDUCT, FROM INCOME, PAYMENTS MADE TO THE ESOT.

Moreover, to facilitate the use of the ESOT

THE COMMITTEE RECOMMENDS THAT SECURITIES LEGISLATION BE AMENDED AS FOLLOWS:

(i) ISSUES OF SHARES BY THE CORPORATION TO THE ESOT SHOULD BE EXEMPT FROM THE PROSPECTUS REQUIREMENTS:

(ii) SUMMARY REPORTING PROCEDURES, SUCH AS FILING FINANCIAL STATEMENTS WHICH CONTAIN MINIMUM INFORMATION, SHOULD BE DEVELOPED TO FACILITATE THE DISTRIBUTION OF SHARES FROM THE ESOT TO THE EMPLOYEES-BENEFICIARIES AND ULTIMATELY TO THE PUBLIC.

The ESOT technique, if supported by the appropriate tax and securities law changes, would be a major incentive to all corporations to issue shares to employees' trusts. These shares would ultimately find their way to public markets.

In this way, the depth and liquidity of the equities market would be improved.

This technique would also constitute a major inducement for wholly-owned foreign subsidiaries to issue shares to Canadians. Some safeguards have to be incorporated in the tax changes to ensure that shares issued in response to this incentive would remain in the hands of Canadians. Accordingly,

THE COMMITTEE RECOMMENDS THAT THE DEDUCTIBILITY FROM INCOME OF PAYMENTS MADE BY THE CORPORATION TO THE ESOT BE AVAILABLE ONLY IF OWNERSHIP OF THE SHARES ISSUED BY THE CORPORATION TO THE ESOT IS LIMITED TO CANADIANS.

The corporate law machinery is already in place to accomplish this by the "constrained share" provisions of the Federal companies legislation.

In connection with the proposal by Kelso that the ESOT technique be supplemented by a public Capital Diffusion Insurance Corporation to guarantee loans by institutions to the employees' trusts, the Committee does not recommend that this be adopted. As the loan by the lending institution to the employees' trust is secured by the guarantee of the corporation and as that guarantee would no doubt be supported by a pledge of the corporation's assets, the Committee is of the view that public insurance would not be necessary.

Compared with the present arrangements, the lender under the ESOT technique has the same security - the assets of the corporation. The Committee can see little justification for the public, through a CDIC, enhancing the lending institutions security even more.

FOOTNOTES

1. The growth of assets and equity of foreign controlled enterprises in Canada are documented in Statistics Canada, Canada's International Investment Position, Catalogue 67-201; and Corporations and Labour Unions Returns Act, Report, Part 1, Catalogue 61-210.

2. Statistics Canada, Canadian Balance of International Payments, Catalogue 67-001 (quarterly) and 67-201 (annual).

3. The current account balance does, however, measure *ex post facto* the economy's net use of foreign savings.

4. Statistics Canada, Financial Flow Accounts, Fourth Quarter, 1972, p. xix, Statement 2, Non-financial Private Corporations Sources and Uses of Funds. Gross domestic saving (internally generated funds) were $9,477 and $7,922 million in 1972 and 1971 respectively. Non-financial capital acquisition was $11,010 and $9,569 million respectively. See also Statistics Canada, Corporation Financial Statistics.

5. Corporations and Labour Unions Returns Act Report for 1970, Part I. During 1967 - 70, by comparison with other firms, those firms which were more than 50 per cent owned abroad reporting under CALURA accounted for a greater proportion of profits than of either sales or assets. For technical reasons comparisons of profits with equity of foreign controlled enterprises are less reliable.

6. See Canada Department of Industry, Trade and Commerce, Foreign-owned Subsidiaries in Canada 1964-67, Ottawa, 1970; Foreign-owned Subsidiaries in Canada 1964-69, and Statistical Supplement, Ottawa, 1972.

7. See CALURA Reports for 1967 to 1970, Part 1.

8. See Financial Flow Accounts, Statistics Canada; Canadian Balance of Internal Payments, Statistics Canada, No. 67-001 and 67-201; Canada' International Investment Position, Statistics Canada 67-202; Security Transactions with Non-Residents Formerly Sales and Purchases of Securities Between Canada and Other Countries, Statistics Canada No. 67-002;

9. See Table 1 and Footnote 7.

10. See Footnotes 5 and 6.

11. See Footnote 7.

12. See, for example, Beigie, Carl E., and Shaffner, Richard, "Funding Canada's Investment Needs: Dimensions of the Task", HRI Observations, No. 3, April 1974, C. D. Howe Research Institute, Montreal.

13. For example, while provincially regulated life insurance companies reporting under The Ontario Insurance Act were authorized by law to invest up to 25% of the book value of total assets in common shares, they in fact invested only about 6.8% in shares in 1972. Ninety-fourth Annual Report of the Superintendent of Insurance for the Province of Ontario, Business of 1972, Toronto, 1973, p. 253; the Insurance Act, R.S.O. 1970, c. 224, s. 385

14. See Bank Act, R.S.C. 1970 c.B-1; Canadian and British Life Insurance Companies Act, R.S.C. 1970, c. I-15; Investment Companies Act, S.C. 1970-71-72,c.33;

Loan Companies Act, R.S.C. 1970 c. L-12; Trust Companies Act, R.S.C. 1970, c. T-16; The Loan and Trust Corporations Act, R.S.O. 1970, c. 254; The Insurance Act, R.S.O. 1970, c. 224; The Securities Act, R.S.O. 1970, c. 426; see also associated Regulations and Policy Statements of the Ontario Securities Commission.

15. Income Tax Act, S.C. 1970-71-72, c. 63 as amended, s.18(4)

16. Statistics on the investment patterns of institutional investors can be found in Statistics Canada publications on financial institutions (generally, and specific sectors), in Reports of the Superintendents of Insurance, and of the Registrars or Superintendents of Loan and Trust Companies, both federal and provincial, and in the Bank of Canada, Statistical Summary. Statistics Canada, Financial Flow Accounts give economy-wide patterns.

17. See G. R. Conway, The Supply of and Demand for Canadian Equities, Toronto, 1970.

18. With the worldwide integration of capital markets and the various Euro-dollar and Euro-currency markets, the European distinctions are to some extent breaking down.

19. There have been relatively minor exceptions. The closeness is illustrated by the exemption of Canada from the U.S. Interest Equalization Tax and the foreign investment controls and by Canada's willingness to take measures to assure it was not used as a backdoor to circumvention of the U.S. policy.

20. The Arab nations have an interest in expanding world supplies of energy, particularly oil, since they wish to reduce the very rapid rate of depletion of their reserves.

21. "Portfolio Investment" refers to investment which is not in the position to control the affairs of the enterprise. Portfolio investment typically includes debt, and non-controlling equity. "Direct Investment" generally refers to investment which is in the position of exercising powers of management and control over the affairs of the enterprise. As a rule of thumb, direct investment involves equity positions of more than 50%; however, investment can be direct with a holding of substantially less than 50% of the equity if the remaining outstanding shares are widely dispersed. Moreover, debt can become a vehicle to exercise management and control over an enterprise by the inclusion of management rights in the debt instrument.